S&P Global
Market Intelligence

CPI Card Group Inc.

NasdaqGM:PMTS

Earnings Call

Tuesday, November 7, 2023 2:00 PM GMT

CALL PARTICIPANTS	2
PRESENTATION	3
QUESTION AND ANSWER	8

Call Participants

EXECUTIVES

Jeffrey A. Hochstadt
Chief Financial Officer

John D. Lowe
Executive Vice President of End-to-End Payment Solutions

Michael A. Salop
Head of Investor Relations

Scott T. Scheirman
President, CEO & Director

ANALYSTS

Harold Lee Goetsch
B. Riley Securities, Inc., Research Division

Jaeson Allen Min Schmidt
Lake Street Capital Markets, LLC, Research Division

Copyright © 2023 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

Presentation

Operator

Welcome to CPI Card Group's Third Quarter 2023 Earnings Call. My name is Chris, and I'll be your operator today. [Operator Instructions].

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

Michael A. Salop
Head of Investor Relations

Thanks, operator, and good morning, everyone. Welcome to the CPI Card Group Third Quarter 2023 Earnings Webcast and Conference Call. Today's date is November 7, 2023, and on the call today from CPI Card Group are Scott Scheirman, President and Chief Executive Officer; Jeff Hochstadt, Chief Financial Officer; and John Lowe, Executive Vice President, End-to-End Payment Solutions.

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 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 this conference call are accessible on CPI's Investor Relations website, investor.cpicardgroup.com. In addition, CPI's Form 10-Q for the quarter ended September 30, 2023, will be available on CPI's Investor Relations website. On today's call, all growth rates refer to comparisons with the prior year period, unless otherwise noted.

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 give a brief business and strategic overview. John will discuss CPI's third quarter performance and our updated outlook for the full year, and then Jeff will review the financial results in more detail before we open up the call for questions.

We will start on Slide 4. As we stated in our second quarter earnings call, we expect the third quarter results to be lower than prior year as customers remained cautious in their spending and continue to work down their inventory levels after stocking up in 2022 due to the significant supply chain challenges across the industry last year.

We are also facing very challenging comparisons with the prior year third quarter when net sales increased 25%. Given this backdrop, third quarter sales this year declined 15%, driven by a reduction in card volumes in our Debit and Credit segments and some timing impacts in prepaid.

As we assess the rest of the year, we believe sales and adjusted EBITDA in the fourth quarter will be at similar levels as the third quarter as it is taking longer than expected for customer spending to rebound and for our new sales initiatives to have an impact. Consequently, we now expect net sales as well as adjusted EBITDA to decline in the mid-single digits range for the year.

Copyright © 2023 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

The market for card production has certainly turned out to be more difficult than expected in 2023. But if we step back and look at the bigger picture, we believe the overall card industry appears healthy. Most importantly, cards in circulation have continued to grow and large issuers have continued to report strength in their card programs which John will discuss more in a few minutes.

Consequently, we remain confident in the long-term health of the market, and we believe we're well positioned for future with our innovative, high-quality products and services, and strong customer focus. As one indicator of our belief in the business, this morning, we announced a $20 million share repurchase program. We believe repurchasing shares is a great investment for our shareholders, and this authorization will run through the end of 2024.

Before turning the call over to John, I would like to highlight our ongoing strategic focus on Slide 5. As discussed, we believe the softness we are experiencing is temporary in nature. The strategies we have successfully employed to grow sales and gain market share since 2017 continue to be our cornerstone, and we remain committed to having deep customer focus, market-leading quality products and customer service, continuous innovation, and a market competitive business model.

Over the long term, we believe our market will return to solid growth, and we believe we will gain share by focusing on these strategic priorities.

I'd now like to turn the call over to John Lowe to further discuss the current environment, our third quarter results, and our outlook for 2023. John?

John D. Lowe
Executive Vice President of End-to-End Payment Solutions

Thanks, Scott, and good morning, everyone. I will start on Slide 6, which is a good indicator of the overall health of the market. As Scott mentioned, payment cards issued to consumers continue to grow. The latest figures from Visa and MasterCard show cards in circulation in the U.S. increased at a 10% CAGR for the 3 years ending June 30, and were up 9% compared with the prior year quarter. Additionally, recent earnings reports from the big U.S. banks also point to healthy card issuance and usage trends with consumers.

As a few examples, Chase noted that cards outstanding increased 16% year-over-year in this third quarter, driven by strong account acquisition. Citi's new account acquisitions increased 5%. And Wells Fargo's new account growth increased 22%.

So the card issuance to consumer side of the market where banks and other issuers participate has been strong in 2023. But the production side where we participate has been relatively soft. However, if you look at our last 2 years together, CPI sales are more broadly in line with the issuance trends to consumers.

Looking back to 2022, we delivered well above average growth with our Debit and Credit segment increasing 32% and as customers had high demand for cards given the limited supply in the market. As the supply chain stabilized and lead times came down in 2023, in combination with economic uncertainty and banking industry stress, customers have pulled back on ordering this year more than we expected and are targeting lower months of supply for their inventory, resulting in our updated outlook of a mid-single-digit sales decline for the year.

Relative to 2021, though, this year's projected sales would still be about 20% higher than the 2021 levels and the combined 2-year trends would be more consistent with the ongoing growth in cards issued to consumers.

Long term, we believe growth in consumer issuance, coupled with the recurring nature of the business, in which the significant majority of card issuance relates to existing card replacement and the ongoing trends towards adoption of higher-priced contactless and eco-focus cards, should support strong growth for the company.

We don't know exactly when customer spending will normalize, but based on indications from our customers, we believe the market will improve gradually over the course of 2024. We will have more

Copyright © 2023 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

visibility and provide more color on our 2024 expectations when we release our fourth quarter results early next year.

But let's return now to our third quarter results on Slide 7. I will provide a few high-level comments, and Jeff will go into more detail in a few minutes. For the quarter, Debit and Credit segment sales declined 16% and prepaid segment sales declined 12%. The prepaid decline can be attributed to timing between quarters as we were only down slightly on a year-to-date basis and still expect the full year sales to be similar to or slightly above last year's levels.

In the Debit and Credit segment, the decline was primarily driven by reductions in card volumes as customers continue to be cautious with spending and focused on working down inventory levels. Card volumes declined across eco-focused, contactless and contact cards in the quarter, while services revenue increased slightly, driven by increases in processing fees due to a larger installation base in our Card@Once instant issuance business.

Despite the sales decline, we have continued to win new business opportunities that should help us in the future. Not only with secure cards, but in card personalization services, Card@Once and prepaid.

From a profitability standpoint, the sales decline in the third quarter negatively impacted operating leverage in our results, leading to net income and adjusted EBITDA margin declines despite reductions in operating expenses. As a result, third quarter net income declined 68% and adjusted EBITDA declined 25% compared to the prior year period. For the first 9 months of the year, sales were down slightly with a 2% decline, while net income decreased 12% and adjusted EBITDA declined 1%.

Slide 8 shows our revised outlook for the year. Based on recent customer feedback, we expect our overall fourth quarter sales levels to be similar to the third quarter. We had previously expected improvement in the fourth quarter based on customer discussions and quoting activity in the summer. But that demand has not materialized as soon as expected.

In addition, the various new sales initiatives we implemented after seeing the market softness earlier in the year, have taken longer to get results than we expected. And consequently, will have minimal impact on this year's results. We expect to see benefit, however, in 2024.

This year's fourth quarter also has challenging comparisons as we posted net sales growth of 36% in last year's fourth quarter. We expect declines in the Debit and Credit segment in the fourth quarter due to reduced card volumes, but we do expect prepaid sales to improve. The fourth quarter expectation translates into a full year outlook of mid-single-digit declines for both net sales and adjusted EBITDA.

We now expect free cash flow to be approximately double the 2022 level, and a year-end net leverage ratio of approximately 3x which would be consistent with the 2022 year-end ratio. Although the overall 2023 outlook is below our expectations coming into the year, we believe we continue to have a strong position in the U.S. marketplace and should be able to quickly capitalize once customers resume normal purchasing patterns.

I will now turn the call over to Jeff to review our third quarter and year-to-date results and outlook in more detail. Jeff?

Jeffrey A. Hochstadt
Chief Financial Officer

Thanks, John, and good morning, everyone. I will begin review on Slide 10.

Net sales decreased 15% in the quarter with Debit and Credit sales declining 16% and prepaid sales declining 12%. Within our Debit and Credit segment, as mentioned, the primary driver of the decline is reduced card sales. Third quarter gross profit decreased 25% and the gross profit margin decreased from 38.9% to 34.1%. The lower sales levels negatively affected margin due to the impact on fixed costs within cost of sales and margin was also impacted by higher material costs, primarily chips, partially offset by lower freight costs.

Copyright © 2023 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

SG&A expenses, including depreciation and amortization declined by $1.8 million in the quarter, primarily due to lower professional services costs. Compensation expenses decreased as lower employee short-term incentive compensation offset $3 million of accruals related to the previously announced executive retention awards and higher headcount and salaries. Our tax rate increased to 37.7% compared to 25.8% in the prior year quarter and brought our year-to-date rate of 30.5%. The increased tax rate expected for 2023 primarily reflects limitations on deductibility of executive compensation related to the executive retention package.

Net income in the third quarter decreased 68% to $3.9 million adjusted EBITDA decreased 25% to $21.2 million. Adjusted EBITDA margin declined from 22.7% in the prior year to 20.1% due to the reduced sales levels and related lower gross margins. The net income decline also reflects the impacts of the executive retention award accrual, which is not included in adjusted EBITDA and a higher tax rate, partially offset by lower interest expense.

Turning now to our year-to-date results on Slide 11. For the first 9 months of the year, net sales decreased 2% with the Debit and Credit segment down 2%, and prepaid debit down 1%. Debit and Credit sales declines primarily reflect lower eco-focus card sales compared to very large orders in 2022, partially offset by increases in volumes of other contactless cards and growth in card personalization and Card@Once instant issuance solution services.

Pricing contributed approximately 3 percentage points of growth in the first 9 months, primarily related to actions taken in 2022. Year-to-date gross profit decreased 6% from the year with gross profit margin decreasing from 36.7% to 35.1%, driven by increased material costs, partially offset by lower freight. Price increases benefited margins, but were largely offset by the negative impact of sales declines.

Total SG&A expenses decreased by $2.8 million in the first 9 months as reduced professional services expenses more than offset an increase in total compensation expense. Year-to-date net income decreased 12% to $21.3 million, and adjusted EBITDA decreased 1% to $69.6 million. Adjusted EBITDA margin increased slightly from 20.2% in the prior year to 20.4%, driven by reduced operating expenses. The net income decline also reflects the executive retention award and a higher tax rate, partially offset by lower interest expense.

Turning now to our segments on Slide 12. I discussed the segment sales drivers earlier, so I will just discuss segment profitability on this slide. Income from operations for the Debit and Credit segment decreased 29% in the quarter to $20.8 million and 4% for the first 9 months. Income declines in both periods were driven by decreased sales and higher material costs, partially offset by lower operating expenses. Prepaid debit segment income from operations decreased 27% in the third quarter to $6.6 million, driven by the sales decline and higher labor costs. Year-to-date income from operations was down 12% due to lower gross profit, which includes higher labor costs and the impact of costs incurred in the first quarter related to the labor conversion at our prepaid production facility partially offset by lower operating expenses.

Turning to the balance sheet, liquidity and cash flow on Slide 13. On a year-to-date basis, we generated $22.3 million of cash flow from operating activities and invested $6.1 million on capital expenditures which resulted in free cash flow of $16.2 million. This compared to the free cash flow usage of $2.7 million in the prior year period with the improvement driven by reduced working capital usage compared to last year's first 9 months.

On the balance sheet, at September 30, we had $10.5 million of cash and $8 million of borrowings outstanding on our $75 million ABL revolver. We had $268 million of senior secured notes outstanding at quarter end as we repurchased $2 million of notes in the open market in the quarter, bringing our total to $17 million year-to-date. Our net leverage ratio of 2.9x at the end of the quarter compared to 3.0x at year-end and 3.6x in the prior year third 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 returning funds to stockholders.

As Scott mentioned earlier, we are pleased to announce a $20 million share repurchase program with the authorization expiring at the end of 2024. Despite the updated lower outlook for full year net sales and

Copyright © 2023 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

adjusted EBITDA, we still expect to generate strong free cash flow improvement, driven by our focus on working capital in a more stable supply chain environment as well as tight management of discretionary spending and projects.

I will now pass the call back to Scott for some closing remarks on Slide 14. Scott?

Scott T. Scheirman
President, CEO & Director

Thanks, Jeff, and thanks to all of our employees for your hard work and dedication in serving our customers well. I would also like to welcome Ravi Mallela, who is joining our Board of Direct as an Independent Member. Ravi is Chief Financial Officer of National Mortgage Holdings, Inc. and we look forward to the financial and business experience he will bring to our Board and Audit Committee.

To summarize today's call, 2023 has turned out to be more challenging than we expected, as economic uncertainties and banking industry stress have contributed to customers being more cautious with their spending as well as more focused on working down inventory levels after the substantial purchases in 2022. Although exact timing is not cleared, we expect customer demand to improve over time, and we continue to believe in the long-term secular trends for payment cards and in our ability to gain share over the long term. We are pleased to put in place a $20 million share repurchase program announced this morning and believe it will be beneficial for shareholders.
Thank you for joining our call today, and we will now open up the call for any questions.

Copyright © 2023 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

Question and Answer

Operator

[Operator Instructions] First question is from Jaeson Schmidt with Lake Street.

Jaeson Allen Min Schmidt
Lake Street Capital Markets, LLC, Research Division

Just looking at the updated full year guidance, I'm just curious if you're seeing any cancellations? Or are these just mainly due to push outs?

Scott T. Scheirman
President, CEO & Director

Hi, Jaeson, it's Scott. Thank you for joining the call. I would say some of it's pushouts. For example, we've had a customer that's in the subprime that are tightening a bit. So there's a bit of a cancellation there. But I would say largely, I think what's important is the secular trends are intact in our business. We operate in attractive and growing markets. As John mentioned on the call, the cards in circulation from Visa and MasterCard are growing at a 10% CAGR. We also are very much in a reoccurring business in that, on average, year-on-year out, there's about over 600 million cards produced. We think about, on average, 90% of those are reoccurring, meaning it's card reissuance, if it's lost or it's stolen. So we feel good about the long-term trends in the business.

The secular tailwinds are there, contactless cards continue to win in the marketplace. They're higher-priced eco-focus cards are out there for sure. Both banks and consumers want to be more environmentally sound. We're the market leader with over 100 million since 2019.

So I think what we're seeing is just a bit of a timing difference, temporary difference between card issuance, card usage. Cards are winning at the expense of cash for sure. The large issuers are continuing to grow that. The production market has just been softer than we expected with cards, cautious spending, some robust purchases in 2022 as a result of a tight supply chain.

But clearly, we believe in the long-term health of the business, we believe we have opportunities on a long-term basis to continue to win share. And we announced a $20 million share repurchase program which represents over 10% of our market cap. So I very much believe in the long-term business.

But again, let me have John. John spent some more time with customers than I do, so he can give you some more color on as far as pushouts or cancellations of what we're seeing.

John D. Lowe
Executive Vice President of End-to-End Payment Solutions

Jaeson, good to talk to you this morning, and Scott covered most of it. The only color I'd add is in the example of a customer where they're credit tightening, where they're in the subprime space. Things like that are going to happen, flow over time. But for the most part, if you take a large issuer as an example, they're kind of cutting back their spending in the current year, but they still have the same book of business. They're still growing their account base.

We still feel good about our position from a share perspective. That's just one example. And we see that across our book of business. So we feel really, really good about where we're positioned in the market. Continue to execute on our strategy, continue to hear good things from our customers.

And I would say the only other thing is probably there is some delayed reissuances in the market, our small to medium space, they're still cautious in their spending. So you definitely see some slowdowns that are continuing into Q4. But the overall card market, as Scott said, right, you're growing at a 10% CAGR over the last 3 years. We saw a 9% growth quarter-over-quarter from Visa and MasterCard. So we still feel very strongly about the position we are in the market and the market self-growing at a decent CAGR.

Copyright © 2023 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

Jaeson Allen Min Schmidt
Lake Street Capital Markets, LLC, Research Division

Okay. That's really helpful. And then just curious if you think the current environment coming out of the supply chain constraints, do you think it has any lasting impact on how customers handle their inventory levels?

John D. Lowe
Executive Vice President of End-to-End Payment Solutions

I'll take that one. I think if you go back to 2021, 2022, and there were a ton of industries that were impacted by this, right? The supply chain was tight. Our lead times are really long. The visibility in our business has come down as lead times have come down but what I would say is we're getting back to more historical times.

Our lead times are a little bit tighter than history. But we don't necessarily see whether it's the large banks, the small to medium banks, changing their broader historical patterns. I think what we see is they built up inventory over the last 1.5 years, and they're starting to normalize that optimize that back down to what I would say normal course patterns.

But what we don't see is banks in general, taking on more risk where they're only going to hold a really, really small amount of inventory and risk not issuing a card to one of their consumers. Their goal at the end of the day is to be top of wallet and everything they do and so they will hold the right amount of cards to make sure they always meet their customers' needs.

Jaeson Allen Min Schmidt
Lake Street Capital Markets, LLC, Research Division

Okay. Appreciate that color. I'll jump back in the queue.

Operator

[Operator Instructions]. The next question is from Hal Goetsch with B. Riley Securities.

Harold Lee Goetsch
B. Riley Securities, Inc., Research Division

I'll stay on this topic. 2022 was a very, very big growth year. I mean it was up 27%. And if you look at maybe your guidance for the full year now, it looks like over a 2-year basis, the revenues are going to be up about 20%. And if the card market is growing roughly what you said kind of at least high single-digit.

My question is like how much inventory in the channel was there that needs to be drawn down? Is it -- can you help us figure out how long this is going to take? Because it would seem that if the -- looking on a 2-year basis now you're -- you exit the year kind of where we think you're going to exit that. It would seem like the consumption over maybe a 2-year period was pretty much in line and like inventories may be get rightsized by Q1. But like I wanted to get your thoughts on that.

And also I wanted to get your thoughts on like, how can we anticipate not getting that kind of channel fill pretty strong again?

John D. Lowe
Executive Vice President of End-to-End Payment Solutions

Yes. Hal, John again. You're right. If you look at the 2-year period, right, the growth of '22 and then take that over '22, '23, compare that to the overall market, things are more in line. From a standpoint of when inventory will fully normalize. Right now, based upon what we're seeing lead times still continue to be low. Our customers, I think, are continuing to optimize. That said, I think we're going to give a lot more guidance in early next year. I don't think we could sit here today and tell you exactly when it will fully normalize and the production market matches up to the card issuance market.

Copyright © 2023 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

But we still feel strong about where we are and your analysis is spot on. That's exactly the way we've thought about it, except for exactly when it will come back. I will say that banks in general, if you go back to where we're in August, they are carrying less months of supply than we expected, but that can't go to zero, right? You think of the 2 billion cards in circulation, the 600 million to 700 million that are produced every year, cards are turning over in every one's wallets roughly every 3 years, regardless of what the expiration date is. So we feel -- it's going to -- the market overall will gradually improve over the course of '24 but we'll give more guidance in early next year.

Operator
There are no further questions at this time. And this will conclude today's CPI Card Group Third Quarter 2023 Earnings Call. Thank you for joining. And have a good day.

Copyright © 2023 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.

Copyright © 2023 by S&P Global Market Intelligence, a division of S&P Global Inc. All rights reserved.

These materials have been prepared solely for information purposes based upon information generally available to the public and from sources believed to be reliable. No content (including index data, ratings, credit-related analyses and data, research, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of S&P Global Market Intelligence or its affiliates (collectively, S&P Global). The Content shall not be used for any unlawful or unauthorized purposes. S&P Global and any third-party providers, (collectively S&P Global Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Global Parties are not responsible for any errors or omissions, regardless of the cause, for the results obtained from the use of the Content. THE CONTENT IS PROVIDED ON "AS IS" BASIS. S&P GLOBAL PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Global Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages. S&P Global Market Intelligence's opinions, quotes and credit-related and other analyses are statements of opinion as of the date they are expressed and not statements of fact or recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P Global Market Intelligence may provide index data. Direct investment in an index is not possible. Exposure to an asset class represented by an index is available through investable instruments based on that index. S&P Global Market Intelligence assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P Global Market Intelligence does not act as a fiduciary or an investment advisor except where registered as such. S&P Global keeps certain activities of its divisions separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain divisions of S&P Global may have information that is not available to other S&P Global divisions. S&P Global has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P Global may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P Global reserves the right to disseminate its opinions and analyses. S&P Global's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription), and may be distributed through other means, including via S&P Global publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.
© 2023 S&P Global Market Intelligence.

Copyright © 2023 S&P Global Market Intelligence, a division of S&P Global Inc. All Rights reserved.