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CPI Card Group Inc.

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Earnings Call

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Call Participants

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Chief Financial Officer

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President, CEO & Director

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Presentation

Operator

Welcome to the CPI Card Group's First Quarter 2024 Earnings Call. My name is Kathleen, 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.

Michael A. Salop
Head of Investor Relations

Today's date is May 7, 2024. On the call today from CPI Card Group are John Lowe, President and Chief Executive Officer; and Jeff Hochstadt, 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 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-Q for the quarter ended March 31, 2024, 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. Now I'd like to turn the call over to President and Chief Executive Officer, John Lowe.

John D. Lowe
President, CEO & Director

On today's call, I will give a brief overview of the quarter and our ongoing strategies. Jeff will go into more detail on the results and our 2024 financial outlook, and then we will open the call up for questions. Let's start on Slide 4. Overall, we are pleased with the first quarter performance, which puts us solidly on track to achieve our full year net sales and adjusted EBITDA financial outlook. As we discussed when we reported our fourth quarter results, we anticipated the first half of this year will be challenging as customers continue to work down their card inventory levels. While card sales declined as expected, this impact was partially offset by strong growth from our prepaid business as well as from our instant issuance and card personalization services businesses within debit and credit.

This resulted in a total net sales decline of 7% in the quarter and sequential growth compared to the fourth quarter in net sales, net income and adjusted EBITDA. Compared to the prior year first quarter, we delivered gross margin improvement and relatively stable adjusted EBITDA margins and also generated solid cash flow. Additionally, we made significant progress advancing our strategies and executing our share repurchase program. Jeff will go into more detail on our financial results in a few minutes. First, I would like to briefly review our strategies on Slide 5. Our strategies reflect the opportunities to grow and gain share in our traditional businesses while also enhancing growth by expanding into adjacent markets, including digital solutions over the long term. Our traditional portfolio includes secure cards, card personalization services, instant issuance solutions, trends on demand and prepaid solutions. Our goal is to continue to gain share in these markets by being the leader in customer service, quality and innovation.

One recent example is the contract we signed in the first quarter to expand the relationship with one of our larger customers, which will result in increased share and incremental sales over the life of the contract, which runs through 2029. It will take some time to transition the incremental business, but this agreement should aid our growth in 2025 and over the next several years. As we discussed last

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quarter, we believe we can supplement core growth over the next few years by expanding into additional markets that are adjacent to our core businesses today. There are two paths for this expansion. One path is leveraging our existing customer base of thousands of financial institutions, most of which are small to medium issuers who rely on third parties for many of their payment services, to provide additional solutions and service offerings to help their customers with their payment needs. An example is digital push provisioning, where we can offer our customers the ability to let their customers seamlessly push their card credentials onto a digital wallet through their mobile banking app, which serves as a complementary offering to physical card personalization.

In the first quarter, we advanced this initiative, including signing a referral agreement with MEA Financial Enterprises, one of the national leaders in providing software solutions to U.S. financial institutions. Through this agreement, we will have the ability to offer push provisioning services to MEA's mobile app users, which include approximately 300 financial institutions. This is one step in opening up the service to both existing and new customers. The second adjacent expansion path involves taking existing products and solutions to new customer types, such as health savings account payment cards and instant issuance for customers beyond the financial institution space. Many of these areas will take some time to develop and drive customer adoption, but we believe there are substantial opportunities to supplement our core growth over the next few years.

In the near term, we remain confident in the overall health of the U.S. card market. As you can see on Slide 6, U.S. cards in circulation continue to grow. The latest figures from Visa and MasterCard show cards in circulation in the U.S. increased at a 9% CAGR for the three years ending December 31 and were up 7% compared to the prior year quarter. Card issuance trends continue to give us confidence that issuers will eventually need to replenish their inventories, which is consistent with the indications we are hearing from our customers. The most recent quarterly earnings reports from the large banks have also demonstrated positive momentum for card programs. We expect the U.S. debit and credit market will continue to grow over the long term, aided by ongoing preferences for cards and the recurring nature of the industry as well as trends towards higher value eco-friendly and other contactless cards. Another recent data point on the ongoing adoption of contactless cards came from Visa, who stated in its latest earnings report the tap-to-pay penetration at point of sale in the U.S. is nearly 50%. We will continue to keep you apprised of market trends and our strategic progress. I would now like to turn the call over to Jeff to discuss our first quarter financial results and 2024 outlook in more detail.

Jeffrey A. Hochstadt
Chief Financial Officer

I will begin my overview on Slide 8. The first quarter environment was generally what we expected for card volumes as customers continue to work down their inventory levels. Overall results improved compared to recent trends as card declines were partially offset by strong growth in prepaid, instant issuance
and our other card personalization services. We also increased gross margins and generated solid cash flow in the quarter. Overall, first quarter net sales declined 7%, net income decreased 50% and adjusted EBITDA declined 8% compared to the prior year period. The net income decrease was impacted by the final accrual for the previously announced executive retention award and other costs related to the CEO transition as well as lower tax rate in the prior year period. Our net leverage ratio was consistent with year-end at 3.1x.

Sequentially, we posted increases in net sales, net income and adjusted EBITDA compared to the fourth quarter, thanks primarily to growth in prepaid and the other services businesses. Turning to the detailed first quarter results on Slide 9. The overall 7% sales decline was comprised of a 14% decrease in our debit and credit segment and a 26% increase in prepaid. Within debit and credit, both contactless and contact card sales decreased as expected compared to the prior year first quarter. Those declines were partially offset by strong growth from Card@Once instant issuance solutions and other card personalization services. Increases in both processing fees and solution sales aided Card@Once as we continue to grow our installation base. While our other card personalization services sales benefited from strong demand for our print on-demand services and incremental fintech business, including services related to tax refund cards.

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The increase in prepaid reflects both strong demand from existing customers, including for our leading tamper-evident packaging solutions as retailers continue to combat fraud, and some timing between quarters. Gross profit in the quarter declined 4% from prior year due to the sales decline. Our gross profit margin improved from 35.7% to 37.1% due to lower production costs, primarily related to labor efficiencies and costs incurred in the prior year quarter when we transitioned our prepaid production facility workforce from temporary to permanent. SG&A expenses, including depreciation and amortization, increased $5 million from the prior year period, primarily due to increased compensation costs partially offset by lower professional services fees. The compensation expense includes the final $2 million accrual related to the previous CEO's retention award as well as some other CEO transition-related items that should come down over the course of the year, primarily relating to executive severance and stock compensation amortization from special grants issued in 2023.

Compared to the prior year quarter, compensation expense also reflects increased salary costs and medical expenses. While the majority of the SG&A increase in the quarter was driven by compensation items that should decrease over time, we expect some of that benefit to be partially offset by strategic growth investments in the coming quarters. Our tax rate in the quarter increased to 28.7% from 20.7% in the first quarter of last year as the prior year period benefited from a favorable adjustment item. Net income in the first quarter decreased 50% to $5.5 million and adjusted EBITDA decreased 8% to $23 million. Adjusted EBITDA margin of 20.5% was down slightly from 20.7% in the prior year as the impact of lower sales and higher operating expenses was largely offset by improved gross margins. As mentioned, the net income decline also reflects the impact of the executive retention award accrual and other CEO transition-related costs, which are not included in adjusted EBITDA, and a higher tax rate.

Turning now to our segments on Slide 10. I discussed the segment sales drivers earlier, so I will highlight segment profitability on this slide. Income from operations for the debit and credit segment decreased 24% to $22.8 million in the first quarter, driven by the sales decline and increased compensation expenses. Prepaid debit segment income from operations increased 138% to $8.7 million, driven by sales growth and lower production costs, including labor efficiencies as the prior year first quarter reflected additional expenses related to the staffing transition in our prepaid production facility. Turning to the balance sheet, liquidity and cash flow on Slide 11. For the first quarter, we generated $8.9 million of cash flow from operating activities and invested $1.5 million in net capital expenditures, which resulted in free cash flow of $7.4 million. This compares to operating cash flow of $8 million and free cash flow of $3.9 million in the prior year first quarter. The higher generation of this year's period was driven by further improvement in working capital and lower net capital spending as we expect CapEx to ramp during the course of the year.

On the balance sheet, we had $17.1 million of cash, no borrowings outstanding on our $75 million ABL revolver and $268 million of senior secured notes outstanding at quarter end and a net leverage ratio of 3.1x, which was consistent with the year-end level. 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. We have made good progress on our share repurchase program, buying back or committing to purchase approximately $6 million against our $20 million authorization through the end of the first quarter. We spent $1.25 million to repurchase 68,000 shares of common stock in the open market in the first quarter and early in the second quarter we completed the purchase of an additional 244,000 shares for $4.4 million from our majority shareholder pursuant to the stock purchase agreement announced in December. Under that agreement, we committed to repurchase shares from our majority shareholder at a ratio of 3:1 to the number of shares we repurchased in the open market from December to March at a price of 98% of the average open market repurchase price over that period. We have a similar agreement for the second quarter that was signed in March.

Turning to our 2024 financial outlook on Slide 12. Today, we are affirming the full year net sales and adjusted EBITDA financial outlook provided in March. Specifically, we continue to project slight increases for the year for both net sales and adjusted EBITDA. We maintain our view that the market will gradually return to growth over the course of the year, and we expect sales declines in the first half of the year to be offset by growth in the second half, which will also reflect anticipated share gains. As John mentioned,

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we recently won greater share with one of our large customers that will provide us incremental business and share over the next several years. This contract requires certain upfront incentives that will negatively impact our cash flow in 2024. Consequently, we have adjusted our full year free cash flow outlook to be approximately half the 2023 level of $27.6 million, which reflects the increased capital spending we discussed in March as well as the incentives related to this contract. We continue to expect our year-end net leverage ratio to be between 3.0 and 3.5x. I will now pass the call back to John for some closing remarks on Slide 13.

John D. Lowe
President, CEO & Director
To summarize, we are pleased with the first quarter performance. Our prepaid card once and other card personalization businesses helped offset expected debit and credit card declines in the quarter and overall results improved sequentially compared to the fourth quarter. While challenges remain in the market, we are on track for the full year and have affirmed our net sales and adjusted EBITDA outlook. Card issuance remains healthy as cards in circulation in the U.S. continue to grow, which gives us confidence the industry will return to more normalized dynamics once inventories are worked down. Long-term market trends are still strong, and we will continue to focus on gaining share in our traditional businesses by leading in customer service, quality and innovation while increasing our addressable market through expansion into adjacencies over time. Operator, we will now open the call up for questions.

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Question and Answer

Operator

[Operator Instructions] Your first question comes from the line of Jaeson Schmidt of Lake Street.

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

Just want to start with that multiyear contract. How should we think about the size and scope of this? Is there a minimum volume levels each year? Or is that over the life of the contract? I guess relatedly, are there opportunities to pursue long-term contracts with other customers?

John D. Lowe
President, CEO & Director

No, we're excited about it. It's a good deal with one of our larger customers. It's a little bit more than a five-year deal actually goes through 2029. Just for context, we do have contracts with a number of our customers, large, small across the business. This one does provide committed values over the next five-plus years and it's a big win for us. We had to provide incentives on the front end to win this deal. At the same time, we're getting fairly large committed volumes on the back end. It's a share gain and ultimately, will benefit our debit and credit side of the business over the next five-plus years.

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

It sounds like the prepaid segment was a little stronger than expected. Was this driven by a single customer with a more broad based?

John D. Lowe
President, CEO & Director

The prepaid business has been performing pretty well over the last number of years. It's less seasonal than it used to be. There's a few things happening there. One, we do see fraud as a greater challenge in the prepaid market. Our team does a good job of building out packages that protect against fraud. We can charge slightly higher prices for those types of packages. That benefits us. We have been expanding in one of our adjacencies that we do out of our prepaid business, which is in the health savings account space. That's been benefiting us. The prepaid business was strong. We did have strong performance with one of our larger customers. Keep in mind, it's a lumpy business as well. There's a little bit of timing there, but a good quarter for our prepaid business.

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

When do you think the excess inventory situation will be fully resolved?

John D. Lowe
President, CEO & Director

It's hard to put a specific point in time on when inventories will be completely worked down or normalized. We did see our expectations met in terms of card performance in Q1. Card volumes were actually slightly up in Q1 from Q4. Keep in mind, there are other businesses that are, let's say, less susceptible to a certain extent. Our personalization services, that's our personalization issuance side as well as our Card@Once instant issuance side. Both of those performed better than expected. We also had some tax season benefits on that side. The card inventories, if you think about the broader market, cards in circulation are still really healthy. 9% growth over the last three years from a CAGR perspective for Visa and Mastercard stats. We still feel that cards as they become worked down, ultimately, we'll see the market normalize. It's hard to put a specific date on when that will occur.

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Operator

Your next question comes from the line of Andrew Scutt from ROTH Capital.

Andrew Scutt
ROTH MKM Partners, LLC, Research Division

First one for me here is on gross margin. You guys had some healthy expansion in the quarter. I was wondering if that was primarily due to mix or if there were other efficiencies mixed in there that helped drive the margin growth?

Jeffrey A. Hochstadt
Chief Financial Officer

We did have a good quarter from a margin perspective. Most of it was really due to our production costs and really primarily related to labor efficiencies. If you recall, Q1 last year, we transitioned in our Minnesota facility from temporary workforce to a more permanent workforce. We had some costs associated with that move. Obviously, we don't have those costs in this quarter. Year-over-year, we were able to improve margins from that standpoint. Also just labor efficiencies across the board. We've been focusing on that, and you see some of that realization in Q1. When you look at prepaid, a lot of times when we grow sales, we get some operating leverage benefit. If you look at our prepaid business, we have strong growth there and generated some operating leverage. When you look year-over-year at debit and credit, we had sales decline, and so you have a lower margin year-over-year in debit and credit. Ultimately, those are the puts and takes. Across the board, it was really the labor efficiencies that drove the margin.

Andrew Scutt
ROTH MKM Partners, LLC, Research Division

My second one here is, a lot of your ancillary services that you guys provide card at once and push provisioning. It seems like those areas have been strong. Just want to talk about the MEA financial partnership you signed one, how long does it take for a partnership for that to ramp to see some meaningful revenues? Are there other opportunities in the market space to sign similar agreements?

John D. Lowe
President, CEO & Director

Another good agreement we're excited about MEA is a good provider of software solutions to financial institutions in the U.S. What we're specifically working with them on is them being a mobile app provider for our push provisioning services. They have about 300 financial institutions that they service that creates our addressable market there. Just for context, what we do on the push provisioning side is a little bit similar from addressable market perspective, if you will, to what we've done in our Card@Once instant issuance side over the years. As a reminder, our Card@Once business, we're in about 15,000 branches across the U.S. We have about 2,200 financial institutions that we've penetrated thus far. That's taken us 9 to 10 years to do that. This is a slow growth penetration, if you will, but it's a strong value proposition for our customers, and it's a good margin business for us as well. It's fairly early days, but we're excited about the deal with MEA and excited about what we're going to do on our broader digital solutions side.

Andrew Scutt
ROTH MKM Partners, LLC, Research Division

I know we're early days in the Indiana facility expansion, but it seems like you guys might have a little more visibility on CapEx here in the year. Is there just any update you guys can give us on the new facility?

Jeffrey A. Hochstadt
Chief Financial Officer

Yes. We mentioned in the last call, we expect about $5 million worth of CapEx related to Indiana this year. That's still the case. In that back half of the year, we'll probably have some OpEx also that hits the SG&A

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line, but that's what we expected so far, nothing different than what we expected at the beginning of the year.

Operator

[Operator Instructions] As there are no further questions in the queue, I would now like to turn the call back over to John Lowe for closing remarks.

John D. Lowe
President, CEO & Director

Thanks, operator. Before we sign off, I want to acknowledge and thank all of our CPI employees for everything they do for our company and our customers every single day. We have outstanding teams who are dedicated and passionate about our business and results. Thank you all for joining our call this morning, and we hope you have a great day.

Operator
Ladies and gentlemen, that concludes today's call. Thank you all for joining. You may now disconnect.

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