CPI Card Group Inc.

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Earnings Call

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Call Participants

EXECUTIVES

Jeffrey A. Hochstadt
Chief Financial Officer

John D. Lowe
President, CEO & Director

Michael A. Salop
Head of Investor Relations

ANALYSTS

Andrew Scutt
ROTH Capital Partners, LLC, Research Division

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

Jacob Michael Stephan
Lake Street Capital Markets, LLC, Research Division

Peter James Heckmann
D.A. Davidson & Co., Research Division

Presentation

Operator

Welcome to CPI Card Group's Fourth Quarter 2024 Earnings Call. My name is Julianne, and I will be your operator today. [Operator Instructions].

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

Michael A. Salop
Head of Investor Relations

Thanks, operator. Welcome to the CPI Card Group Fourth Quarter 2024 Earnings Webcast and Conference Call. Today's date is March 4, 2025. And 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-K for the year ended December 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.

The agenda for today's call is on Slide 3. John will give a brief overview of business performance and our strategies, Jeff will provide more detail on the financial results and our 2025 outlook, and then we will open the call for questions.

We can start on Slide 4, and I'll turn the call over to John.

John D. Lowe
President, CEO & Director

Thanks, Mike, and good morning, everyone. Overall, we are pleased with the fourth quarter results and what we accomplished in 2024. Looking back on my first year as CEO, there are several important areas I would like to highlight.

First, we refined and advanced our strategy, maintaining our emphasis on customers and quality while also increasing our focus on innovation and diversification. This includes intensifying efforts to expand into adjacent markets by providing new offerings for our existing customer base and delivering existing solutions to new customer verticals. We also enhanced the management team, promoting from within to balance our leadership, talent and skills and bringing in outside expertise to support our next stage of growth. And we delivered good results, returning to growth despite the channel inventory challenges in our debit and credit card business.

Our prepaid business produced exceptional performance, growing 26% for the year and exceeding $100 million in net sales. This growth was driven by strong demand for our packaging solutions focused on fraud prevention and expansion of one of our adjacencies, the health care payment solutions vertical. Our debit and credit business increased 4% for the year, with strong growth in the second half, led by sales of eco-focused contactless cards.

In addition to our recovered ocean-bound plastic and other more environmentally friendly debit and credit card offerings, we are also seeing strong market response to our eco-focused offerings in the prepaid space. In total, we have sold more than 350 million eco-focused credit, debit and prepaid card or packaging solutions since launch, with prepaid contributing more than $200 million of these since certification in 2023.

Overall, we continue to win business across our portfolio in 2024 and believe we gained market share during the year. We also generated strong free cash flow, exceeding $34 million for the full year while increasing our capital spending investments. And we completed several key capital structure actions during the year that we believe enhanced our market positioning.

We purchased $9 million of stock at an average price of just over $18, which we view as a strong investment for our shareholders. We refinanced our debt, including issuing $285 million of new senior notes that extended our debt maturities to 2029. And we completed a 1.4 million share secondary offering of common stock on behalf of our majority shareholder, which reduced its holdings from 56% to 43% of shares outstanding, increased our public float and brought in new shareholders.

Turning to our 2025 outlook. We currently project mid- to high single-digit net sales growth for the year, led by our debit and credit business, which reflects our goal to continue to gain market share. We believe the channel inventory situation is much improved, but it's still above historical levels, and we expect the market to continue to normalize during the year.

We expect adjusted EBITDA growth of mid- to high single digits in 2025 as well, which reflects increased investments for the future, including for our innovation and diversification strategies. We also expect to generate strong free cash flow and reduce net leverage by year-end. Jeff will provide you more detail on our results and outlook in a few minutes.

But first, let me highlight our strategy on Slide 5. Our vision is to be the most trusted partner for innovative payments technology solutions. We aim to support that vision by providing market-leading high-quality payment solutions and best-in-class customer service. In managing our business, we focus on 4 main strategic pillars: customer focus, quality and efficiency; innovation and diversification; and people and culture.

Our focus on the customer is evidenced by our Net Promoter Scores, where we have consistently ranked high relative to peers and continue to get better. The innovation and diversification pillar includes our efforts to expand our addressable markets by offering new solutions to existing customers and existing solutions to new customer verticals. We have already made significant progress in advancing these expansion strategies, including increasing our addressable market through offerings of health care payment solutions, which contributed to our strong prepaid growth in 2024.

The new areas we have entered have increased our total addressable market from $1.5 billion related to our traditional core businesses to approximately $2 billion, and there is more opportunity to come. For example, we are in the early stages of investment to support the penetration of the closed-loop prepaid market in the U.S., where many customers are shifting to higher-value secure packaging solutions due to regulation or proactive moves to combat fraud.

And we continue to advance our digital solutions, such as push provisioning for mobile wallets with more integrations and implementations underway with additional mobile banking app providers and platforms as we continue to make our services more available to the broader market. While new solutions generally take time to gain adoption and turn into meaningful revenue, these opportunities leverage existing strengths, and we believe they will allow us to further expand our total addressable market in the future.

We also remain confident in the long-term growth of our traditional markets as payment card issuance continues to grow in the U.S. We are stepping up investments in 2025 to take advantage of these opportunities through both CapEx and OpEx. This includes investment in our Indiana factory for developing digital solutions and closed-loop prepaid capabilities, among other initiatives as we balance generating strong profitability in the near term with accelerating our long-term growth.

Overall, we expect 2025 to be a good year, and we also plan to make strong progress on our various market expansion initiatives.

I would now like to turn the call over to Jeff to review our financial results and outlook in more detail. Jeff?

Jeffrey A. Hochstadt
Chief Financial Officer

Thanks, John, and good morning, everyone. I will begin my overview on Slide 7. Net sales increased 22% in the fourth quarter, led by great performance from prepaid as well as growth in debit and credit card volumes and personalization services. Adjusted EBITDA increased 10% and net income more than doubled. Free cash flow was very strong as we generated more than $34 million for the year despite higher capital spending.

Turning to the detailed fourth quarter results on Slide 8. The overall 22% sales increase reflected a 59% increase in our prepaid segment and a 12% increase in our debit and credit segment. Prepaid growth was driven by continued strong demand for higher-priced fraud focused packaging solutions as well as incremental growth from nonfinancial customer verticals, including our health care payment solutions. Debit and credit card growth was led by contactless with strong growth from eco-focused cards. Gross profit increased 20% in the quarter, while gross margins decreased from 34.4% in the prior year quarter to 34.1% as operating leverage was offset by some negative product mix.

SG&A, including depreciation and amortization, increased $1.8 million from the prior year primarily due to increased compensation expenses, including higher employee performance-based incentive compensation expense, partially offset by expense related to the previous CEO retention agreement in the prior year. The tax rate in the quarter of 17.9% reflected benefits related to a statute of limitations expiration. Net income increased 148% driven by sales growth, a lower effective tax rate and the impact of the CEO retention expense in the prior year. Adjusted EBITDA increased 10% to $21.9 million, while adjusted EBITDA margins declined from 19.3% to 17.5%.

Turning now to our full year results on Slide 9. Net sales increased 8% for the full year, which reflected 26% growth from the prepaid segment and 4% from debit and credit. Prepaid delivered an exceptional year, well above our original expectations. The debit and credit segment increase was driven by growth in contactless cards, Card@Once instant issuance and personalization services. Card growth was led by strong performance from eco-focused contactless cards and contactless overall represented approximately 90% of our chip card volume in 2024, up from just over 80% in the prior year.

Full year gross profit increased 10% as gross margin increased from 35.0% to 35.6%, driven by operating leverage from sales growth. SG&A increased $14.5 million from the prior year, driven by increased employee performance-based incentive compensation as we returned to growth following a challenging year in 2023, investments in people and increased medical costs.

Interest expense increased $7.2 million for the year, primarily due to the $5.8 million call premium paid to redeem our senior notes due in 2026 in the third quarter. Other expense reflects a $3 million loss on debt extinguishment, which was also recorded in the third quarter. The full year tax rate of 22% declined versus the prior year rate of 30.4% due to increased stock compensation deductibility and the benefits realized related to a statute expiration in 2024 as well as limitations on executive compensation deductibility in the prior year. We expect the rate to be in the mid- to high 20% range moving forward.

Net income for the full year decreased 19% to $19.5 million with the reduction primarily due to the $8.8 million of pretax debt refinancing costs incurred in 2024 and increased SG&A, partially offset by sales growth, gross margin expansion and a lower effective tax rate. Adjusted EBITDA increased 3% to $91.9 million and adjusted EBITDA margin declined from 20.1% to 19.1%, primarily due to increased employee performance-based incentive compensation expense.

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 7% in the fourth quarter, primarily due to negative product mix and 2% for the year, primarily driven by the impact of increased compensation-related expenses. Prepaid debit segment income from operations increased 106% in the quarter and 49% for the year, driven by sales growth and margin expansion from operating leverage.

Turning to the balance sheet, liquidity and cash flow on Slide 11. We generated $43.3 million of cash from operating activities in 2024 and invested $9.3 million in capital expenditures, which resulted in free cash flow of $34.1 million. This compares to operating cash flow of $34 million and free cash flow of $27.6 million in 2023. The increased generation in 2024 was primarily driven by higher net income excluding the debt refinance costs and improved working capital, including lower senior note interest payments due to refinancing timing, partially offset by a $3 million increase in capital spending.

On the balance sheet, at year-end, we had $33.5 million of cash, no borrowings on our ABL revolver and $285 million of senior notes outstanding. Our net leverage ratio was 3.0x, down from the 2023 year-end level of 3.1x despite cash outflows during the year for share repurchase and the debt refinancing. Our capital structure and allocation priorities remain focused on investing in the business, including possible strategic acquisitions, deleveraging the balance sheet and returning funds to stockholders. In 2024, we bought back approximately $9 million of our common stock and our authorization expired at year-end.

Before we move on to our 2025 outlook, we have provided the latest U.S. cards and circulation trends from Visa and Mastercard on Slide 12. For the 3 years ending September 30, cards in circulation in the U.S. increased at a 9% CAGR. In addition, the February Nielsen report indicated the total number of general purpose credit cards in the U.S. increased 7% in 2024. This was driven by both growth in the number of cardholders and a 3.5% increase in the number of cards per cardholder, which stood at more than 5 credit cards per holder in 2024.

Nielsen also reported a 9% increase in the total number of credit and debit cards for the year, including general-purpose prepaid cards. The latest earnings reports from large bank issuers have indicated healthy account growth and card business outlooks as well. The data continues to show positive issuance trends as well as cards remaining the predominant form of payment for in-person transactions in the U.S., further supporting the card growth dynamic.

Turning now to our 2025 outlook on Slide 13. We expect a good year in 2025. Although channel inventories of credit and debit cards are still being worked down, positions are better than last year, and we expect the market to continue to normalize. Our outlook projects mid- to high single-digit net sales growth for 2025, led by our debit and credit segment. We are not planning significant growth from our prepaid segment coming off the record levels reached in 2024, but we do expect to make some inroads into the closed loop market late in the year as our capabilities become operational.

We expect adjusted EBITDA growth to also be mid- to high single digits as we ramp up investments in digital, our Indiana factory and other areas to drive long-term growth. From a quarterly perspective, we expect net sales and adjusted EBITDA growth to be strongest in the second half of the year. For the first quarter, we expect sales to increase but currently anticipate adjusted EBITDA to be slightly down due to timing of spending and mix. We expect our full year 2025 free cash flow to be slightly below the 2024 level due to increased cash interest expense, driven by the timing of our refinancing last year and higher rates and increased capital spending.

The increased CapEx in 2024 and 2025 for our Indiana production facility and other sales-related machinery will also impact depreciation and amortization expense in our P&L, and we expect D&A and cost of sales to increase by approximately $3 million in 2025, although this does not impact EBITDA. Finally, we expect to reduce our net leverage ratio to below 3.0x by year-end, driven by growth in adjusted EBITDA and strong cash flow generation.

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

John D. Lowe

President, CEO & Director

Thanks, Jeff. To summarize, we made a lot of strategic progress in 2024, generated good results and finished the year strong. Our prepaid business was outstanding. Our debit and credit business grew despite challenges and we generated strong free cash flow while investing for the future. We also completed significant capital activities, which should benefit our company and shareholders in future years. We are projecting a good year in 2025, and we'll continue to execute our strategies to gain share and expand our addressable markets and drive long-term growth. We look forward to reporting our progress.

Operator, we will now open the call up for questions.

Question and Answer

Operator

[Operator Instructions] Our first question comes from Andrew Scutt from ROTH Capital Partners.

Andrew Scutt
ROTH Capital Partners, LLC, Research Division

So the first one here, I'm going to try and tie a couple of questions into one. But the prepaid results were very strong. You guys kind of touched on the sales drivers there. Could you kind of give some detail around the gross margins, which were also very chunky? And then also kind of dig a little bit more into some of those verticals you touched on that are performing well in prepaid, including, I think you said some health care payments and as well as your eco-friendly cards. So any details there would be great.

John D. Lowe
President, CEO & Director

Yes, Andrew, -- so let me -- I'll cover part of your 2 questions, and then I'll pass it off to Jeff. But yes, our prepaid team did a great job. We've seen a lot of progress in the prepaid space in terms of higher-value packaging due to fraud protection and the innovation of our team up in Minnesota working with our customers. And that really benefited us in 2024, and we're happy about that performance.

In terms of our verticals, health care definitely has been a vertical that has been a good adjacency for us. We started that a couple of years ago and really saw great progress in 2024. That's part of the reason for the growth in prepaid, especially Q4, I believe, was up nearly 60%. So kudos to the team. In eco, we've actually been doing that. We became certified under FSC certification in 2023. And since that point in time, along with the rest of our company, prepaid has really taken a position of moving most of what we produce from a paper perspective into eco-focused in some way, shape or form. And so they've contributed significantly to our eco-focused production along with what we do in our card manufacturing side. So happy about that as well.

But let me let Jeff cover the gross margin side.

Jeffrey A. Hochstadt
Chief Financial Officer

Andrew, you're right, the gross margin for the year, we did -- we were able to increase gross margins by 60 basis points. So we feel good about continuing to generate operating leverage. But I think Q4, you kind of probably see that really strong gross margins in prepaid, obviously, really strong growth in Q4 in prepaid, leading to more operating leverage in that segment. In debit and credit, we talked about this from time to time. There are some mix issues. We had a couple of sales in Q4 that were particularly lower margin sales that a little bit more unusual, but that happens from time to time. And we still feel really good about our operating model as we grow, continue to be able to gain operating leverage. In the future, it's just about how much -- balancing how much we reinvest back in the business from an EBITDA perspective.

Andrew Scutt
ROTH Capital Partners, LLC, Research Division

Second one from me. You guys gave some details around the inventory clearance. It sounds like second half of '25 we should really see some progress there. You guys did liquidate looked like around $20 million in inventory. Can you just -- any additional color from what you provided in the prepared remarks would be great.

Jeffrey A. Hochstadt
Chief Financial Officer

Yes, if you look at our inventory balance, I think that's what you're talking to on the balance sheet. You did see that we have this longer-term agreement, commitment of purchasing chips. It goes through the beginning of 2026. So it really has to do with the timing of purchasing. We do feel like throughout 2025, it might -- the inventory balance might go up a little bit, but by the end of the year, similar to what happened -- what you saw in 2024, we should be able to bring that balance -- that inventory balance down. So it's really about the timing of committed purchases.

Operator

Our next comes from Peter Heckmann from D.A. Davidson.

Peter James Heckmann
D.A. Davidson & Co., Research Division

Could you talk a little bit about -- a little bit more about what you need to do as a company and just the marketing efforts to penetrate that prepaid closed-loop market? And if you talk about kind of the size of it and where you might start? I mean I would assume you're already working with a lot of those customers on the open loop side. But yes, we talked about entering that closed loop in a more significant way? And how big that could be?

John D. Lowe
President, CEO & Director

Yes. The closed loop side is definitely -- it is larger than the open loop. And just as a reminder for those following us. We are predominantly in open loop secure packaging of gift cards. That's been our bread and butter for a number of years. Closed loop historically has been lower value. It's what you see when you walk into a Starbucks, if you will, to get a Starbucks card that you can only get in Starbucks. But given the change in regulatory environment, given the need for fraud protection, it's actually bleeding into the closed loop side as well, that market, which we believe is 4 to 5x greater in size than the open loop market is a good opportunity for us. It's a longer-term opportunity.

And Pete, to your point, our customers that we are selling open loop into also have relationships on the closed loop side. So that benefits us as well. So we are making investments to move into closed loop expansion. We have been doing some closed loop on a very small scale. But those investments won't necessarily arrive and give us the capacity and capabilities to expand until late in '25. So we would expect a small impact on 2025. But the punchline is the closed loop market is a great market for us, and we are the leader in secure packaging from a gift card perspective in the U.S. And because of that, we feel like we're well positioned to capitalize on the closed-loop market.

Peter James Heckmann
D.A. Davidson & Co., Research Division

Okay. That's good to hear. That's good to hear. And then just an update on the facility in Indiana. Do you expect that to go online here later this year?

John D. Lowe
President, CEO & Director

Yes. The -- our Indiana facility is on track. We expect to be up and running in the second half of '25. But Jeff, would you add any color to that?

Jeffrey A. Hochstadt
Chief Financial Officer

Yes. No. I think we're excited about getting the facility online. We've talked about it in the past, we're buying some new equipment, some automation, we're really looking forward to putting some of the production through the new facility and being able to gain some efficiencies. So we're quite excited. Right now, it's pretty much on schedule. There are no significant hiccups, and we should be operational, like John said, second half of the year.

Peter James Heckmann
D.A. Davidson & Co., Research Division

Okay. Great. So any CapEx related to that, that would likely be in the first half, do you think?

Jeffrey A. Hochstadt
Chief Financial Officer

Yes. I mean, yes, we will have -- you're right, this year, there will be some more CapEx associated with Indiana. And John was just talking about the closed loop opportunity there will be some CapEx there to buy some more capacity, some equipment that will be more specialized to the closed loop opportunity.

So we do feel like -- just in terms of CapEx, if you look at the last few years, our CapEx has been a little bit lumpy, anywhere from $6 million a year to $18 million a year. If you go back to the last 3 years, we'll probably be closer to the higher end of that in 2025 in terms of CapEx just because of these 2 -- mainly because of these 2 areas and some other equipment we're purchasing as well.

Peter James Heckmann
D.A. Davidson & Co., Research Division

Okay. Great. And I think you had said in the press release that you would expect free cash flow to be maybe down just a little bit or close to the level of 2024, correct?

Jeffrey A. Hochstadt
Chief Financial Officer

Yes, we do have not only the higher CapEx that we just mentioned. But relative to 2024, we do. In 2024, we actually had 10 months of cash interest paid, if you will, just based on a refi. So we'll go back to a more normal 12 months of cash interest expense in 2025. So on a relative basis, that also has an impact. But that kind of offsets the higher profitability in 2025.

Operator

[Operator Instructions] Our next question comes from Jacob Stephan from Lake Street.

Jacob Michael Stephan
Lake Street Capital Markets, LLC, Research Division

Congrats on the quarter. Maybe just to start off, I wanted to delve into kind of the health care market a little bit. Obviously, you gave some good color, 60% growth in Q4. But when I think of health care, I think donor incentives, co-pay programs, what are kind of the verticals within prepaid that you're seeing strength within the health care?

John D. Lowe
President, CEO & Director

Yes, Jacob, just the 60% growth was actually our broader prepaid business, just to make that clear. But the health has been a strong contributor of ours. Think about when you're receiving an FSA card and HSA card in the mail, it's got all the marketing materials around it. You've got to do that in high volume, high variability, high accuracy in that benefits time frame late in the year. And then throughout the year, that's another area of the broader U.S. payment card market where people lose their cards, they switch companies for whatever reason, they need a replacement or something new sent to them.

So that's a vertical that we haven't been in, if you go back and look at us historically. So we entered into that in the last couple of years. And it's a good market for us. It's a growing market with the broader economy. And in addition, it's a very much a recurring market once you get in and you do it well. So a lot of these types of issuance cycles that occur annually in or, again, high volume, high variability and you have to be highly accurate. That's where we excel, and they are quasi-prepaid cards, hence why they fit in our prepaid segment.

Jacob Michael Stephan

Lake Street Capital Markets, LLC, Research Division

Got it. Understood. That's really helpful. And maybe just kind of to dig a little bit deeper on the kind of margin impact of that health care business. Are margins relatively similar to kind of the prepaid credit and debit or slightly higher given the secured packaging nature and kind of customization?

John D. Lowe
President, CEO & Director

Yes. I mean, I don't know if we'd comment specifically on the margins for health care in general, but it's a good vertical to move into. Margins as well as pricing, it's all based upon value proposition of what you're providing to your customers. Our goal is to provide innovative, differentiated solutions and hold strong margins across the business. But our prepaid business broadly does have strong margins, it has for a number of years. And that's because of the value proposition that we provide to our customers there.

Operator

Our last question will come from Hal Goetsch from B. Riley.

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

Terrific quarter and outlook. I wanted to ask about the prepaid segment in Q4. You might have covered this, I just want to make sure I understand it. The revenue was up 26% and the commentary of the existing customers and you had sales of higher value-added packages that implies like the higher value-added packaging has higher pricing? And just kind of curious what's the trade-off between volume and price to get to that 26%?

Michael A. Salop
Head of Investor Relations

Yes. Just to clarify, Hal, 26% was for the full year. Yes, we don't break out necessarily volume versus value, I'd say the health care is volume driven. That's incremental units. A lot of the other business was more value driven, just higher value solutions with our customers.

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

Okay. And maybe in retail is there like a completely shift in pricing for more security things you've mentioned that you'll lap that at some point where all the installed base and the inventory in the channel is the higher -- the more secure and the better packaging that how many -- is that largely complete? Or are we still early in that?

John D. Lowe
President, CEO & Director

Yes, Hal, it's a good question. And we haven't necessarily commented on the entire retail prepaid market transition to the higher value packaging. There are pockets that we've been moving to higher-value packaging to protect against frauds. That said, even in 2024, as we did that, there were also pockets where we were doing replacements of what's out there in the market today. So you saw probably a little bit of onetime, if you will, from that, which we haven't necessarily quantified.

But my point is prepaid had a great year in '24. In '25, we expect it to be relatively flat for the most part. And that's because of some of that lumpiness that occurred in 2024. But broadly, if you look at the market longer term, we are well positioned if that market continues to transition further, but it's hard to say how much the penetration of the entire prepaid market will move to higher value packaging to protect against fraud.

Operator

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

John D. Lowe
President, CEO & Director

Thanks, operator. I want to again acknowledge and thank all of our CPI employees for everything they do for our company and our customers as they execute on our vision, values and strategies every day and continue to drive our business forward. Thank you this morning, and we hope you have a great day.

Operator
This concludes today's conference call. Thank you for your participation. You may now disconnect.