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CPI Card Group Inc.

NasdaqGM:PMTS

Earnings Call

Wednesday, May 7, 2025 2:00 PM GMT

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Call Participants

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Presentation

Operator

Welcome to the CPI Card Group's First Quarter 2025 Earnings Call. My name is Karen, and I will be your conference 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

Thanks, operator. Welcome to the CPI Card Group First Quarter 2025 Earnings Webcast and Conference Call. Today's date is May 7, 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-Q for the quarter ended March 31, 2025, 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.

As you've likely seen from this morning's press releases, in addition to reporting our first quarter results today, we are excited to announce the acquisition of Arroweye Solutions, a leading provider of digitally driven on-demand payment card solutions for the U.S. market. This acquisition fits in nicely with our strategies to gain share and diversify our business, and I'll talk more about this in a few minutes. First, I'll comment on our first quarter results and 2025 outlook. We are pleased with the first quarter sales performance led by our debit and credit card portfolio and continued strength from prepaid solutions. Both of our segments increased 10% in the quarter, with debit and credit growth led by strong sales of contactless cards, including eco-focused cards and prepaid driven by our higher-value packaging solutions and growth in health care payment solutions. As we mentioned last quarter, we expect adjusted EBITDA to decline in the first quarter due to anticipated mix issues and timing of spending. We did experience these mix impacts and some added production costs, which resulted in an 8% decline in adjusted EBITDA compared to last year's first quarter.

Although there is uncertainty in the market regarding the U.S. economic outlook and there is the potential for additional tariff issues, current demand from our customers remains healthy, and we are affirming our 2025 organic outlook for mid- to high single-digit growth for net sales and adjusted EBITDA. For the remainder of 2025, we are focused on driving sales growth while balancing investing for the long term with managing spending to improve margins as the year progresses. Even in this environment,

we continue to invest in key strategic projects, including our new Indiana facility, opportunities within the closed-loop prepaid market, digital solutions and now the Arroweye acquisition. Jeff will provide you more detail on our results and outlook in a few minutes. But first, let me highlight our strategy and how Arroweye fits in, starting on Slide 5. As a reminder, our vision is to be the most trusted partner for innovative payment technology solutions. We aim to support that vision by providing market-leading, high-quality payment solutions and best-in-class customer service.

One of our strategic pillars focuses on innovation and diversification to expand our addressable markets by offering new solutions to existing customers and existing solutions to new customer verticals. Adding Arroweye to CPI's portfolio is a perfect example of this, which I will discuss on Slide 6.

As I mentioned earlier, Arroweye is a leading provider of on-demand payment card solutions, featuring a fully integrated end-to-end digital-driven process that facilitates card production, personalization and fulfillment. Arroweye's technology-driven platform eliminates the need for customers to hold inventory and allows for hyper-personalization and rapid turnaround times on new programs. We believe combining Arroweye Solutions with CPI's existing portfolio will allow us to offer even more differentiated and innovative solutions and gain share with both companies' customers. Arroweye has historically supported a segment of the market where we have limited presence, resulting in minimal customer overlap. We would expect Arroweye's full year revenue to be in the mid-\$50 million range, although we will only have a partial year included in our results in 2025.

The business currently has low double-digit adjusted EBITDA margins, although margins may be on the lower end in 2025 as we navigate combining the companies. Over time, we believe there will be revenue, sourcing and other cost synergies, which will bring margins closer to CPI levels. We will take on Aero's production facility in Las Vegas, which was completed in 2022 and provides state-of-the-art on-demand capabilities and their approximately 200 employees. Arroweye is a business we have known in the market for years, and we're very familiar with our on-demand capabilities. As we engaged in the acquisition process, we were even more impressed with their position in the market, capabilities, teams and technology-driven production process and facility. We believe this acquisition can generate a great return for CPI and our shareholders. The purchase price to acquire Arroweye is aligned with CPI's recent market multiples.

And given our belief in revenue and cost synergy opportunities, we anticipate strong adjusted EBITDA contribution and earnings accretion over time. We see this as a great fit with CPI and look forward to combining these 2 great organizations. We will give you more color on Arroweye next quarter after we have operated the business for a few months. But now I'd like to turn the call over to Jeff to review our first quarter financial results and full year outlook in more detail. Jeff?

Jeffrey A. Hochstadt
Chief Financial Officer

Thanks, John, and good morning, everyone. I will begin my overview on Slide 8 with the first quarter highlights. Net sales increased 10% in the first quarter, led by strong performance from debit and credit cards and continued growth in prepaid. The first quarter gross margin was impacted by negative sales mix and increased production costs, which resulted in adjusted EBITDA declining 8% in the quarter. We expect similar margin pressures in the second quarter before seeing improvement in the second half of the year despite tariff impacts due to operating leverage and better mix, especially in the fourth quarter.

Free cash flow was slightly positive in the first quarter as cash flow generated from operations was primarily utilized for capital spending, including our new Indiana production facility. Turning to the detailed first quarter results on Slide 9. The overall 10% sales increase reflected a 10% increase in both our debit and credit and prepaid segments. Debit and credit growth was led by contactless cards with strong growth from eco-focused cards, partially offset by a decline in personalization services. Prepaid growth was driven by continued strong demand for higher-priced fraud prevention packaging solutions in our health care payment solutions. The gross profit margin decreased from 37.1% in the prior year quarter to 33.2% as operating leverage from sales growth was offset by negative sales mix and increased production costs. Increased production costs reflect some operational inefficiencies, which we expect to diminish over the course of the year as well as incremental costs as we operate 2 production facilities in Indiana during our

transition to the new site. SG&A, including depreciation and amortization, decreased almost \$1 million from the prior year as the 2024 first quarter includes the final cost related to the prior CEO retention agreement and other executive severance.

Net income decreased 12%, primarily due to lower gross profit and higher interest expense, partially offset by lower operating expenses. Adjusted EBITDA decreased 8% to \$21.2 million, while adjusted EBITDA margin declined from 20.5% to 17.2%, driven by the lower gross margin. 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 5% in the first quarter as sales growth was offset by lower gross margins and increased operating expenses. Debit and credit gross margins increased compared to the fourth quarter, but were impacted by sales mix and increased production costs compared to the prior year first quarter. Prepaid debit segment income from operations decreased 9% in the quarter as benefits from sales growth were offset by lower gross margins, which were impacted by sales mix, including comparisons with a very strong margin in the first quarter of last year. Turning towards the balance sheet, liquidity and cash flow on Slide 11. We generated \$5.6 million of cash from operating activities in the first quarter and invested \$5.3 million in capital expenditures, which resulted in free cash flow of \$0.3 million.

This compared to operating cash flow of \$8.9 million and free cash flow of \$7.4 million in the prior year. The decreased generation compared to the prior year was primarily due to an approximately \$4 million increase in capital spending, which is supporting the build-out of our new Indiana secure card production facility. Cash flow was also impacted by lower net income, excluding noncash items and slightly higher working capital usage, including the impact of higher interest expense payments related to our senior notes. On the balance sheet, at quarter end, we had \$31.5 million of cash, no borrowings on our ABL revolver and \$285 million of senior notes outstanding. Our net leverage ratio at quarter end was 3.1x, up slightly from the 2024 year-end levels of 3x.

Our capital structure and allocation priorities remain focused on investing in the business, including acquisitions such as Arroweye, deleveraging the balance sheet and returning funds to stockholders. 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 December 31, cards in circulation in the U.S. increased at a 9% CAGR.

Despite market uncertainties on the economic outlook and tariffs, the latest earnings reports from large bank issuers have continued to indicate strong account growth for card businesses, which is consistent with the customer demand we are seeing in the market. A change in the economic environment towards recessionary conditions could affect issuances and customer purchases, but at this point, customer demand remains healthy. Turning now to our 2025 outlook on Slide 13. We have affirmed our organic net sales and adjusted EBITDA outlook as we continue to expect mid- to high single-digit growth for both. The outlook does not include any contribution from the Arroweye acquisition and does not reflect any significant change in economic conditions.

It does include the impact of tariffs that have been put in place as well as cost savings activities we have recently undertaken to counter the pressures from first half mix issues and projected impact from tariffs. Although our supply chain does not have material exposure to current tariff policies, we do procure some materials from China and Europe and currently project incremental costs of approximately \$2 million, which is included in our outlook. We are making changes in our sourcing where possible to mitigate these tariff impacts.

Semiconductor chips, our largest component in terms of value, are currently exempt from tariffs. Any change to remove the exemption or create a specific tariff for chips would likely impact our outlook. Arroweye will add to our expected sales and adjusted EBITDA for the remainder of the year, and we will give more color on these expectations next quarter. Due to expected integration costs and some potential incremental CapEx to accelerate key Arroweye projects, we are not providing a free cash flow outlook this quarter.

We do expect free cash flow to be lower than previously forecast due to these Arroweye items as well as timing of inventory purchases and tariff impacts on capital expenditures on the CPI business. Similarly,

our net leverage ratio will be impacted by the Arroweye acquisition. Excluding Arroweye, we would still project the ratio to be below 3x at year-end, but financing the acquisition with cash and borrowings should temporarily move it above 3x this year. We plan to work the ratio back down in 2026.

We expect the impact to earnings per share from Arroweye to be dilutive in 2025 and slightly dilutive in 2026 due to integration and financing costs before turning accretive in 2027. As noted in our press release, the purchase price for Arroweye was \$45.55 million, which we funded using cash on the balance sheet and borrowings from our \$75 million ABL revolving credit facility. We also anticipate being able to utilize around \$5 million of Arroweye net operating loss tax benefits in the coming years. We will provide more insight on Arroweye's expected impact in future quarters. 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 delivered good sales growth in the first quarter and are affirming our full year net sales and adjusted EBITDA outlook despite some cost pressures from sales mix and tariffs. Customer demand remains healthy, although there is uncertainty in the market, and we are managing spending in response. We are excited about the Arroweye acquisition and adding their zero inventory on-demand solutions to the CPI portfolio, boosting our strategies to diversify the business and drive long-term growth. Operator, we will now open the call up for questions.

Question and Answer

Operator

The first question comes from Pete Heckmann from D.A. Davidson.

Peter James Heckmann

D.A. Davidson & Co., Research Division

Congratulations on the Arroweye deal. I want to know if you could give us a little bit more color on exactly where they play. Are they a customer of another card production firm? Or are they doing all of their own card production? And how would you characterize their customers? I think you said low customer overlap, but would it be the same type of customers, both large issuers, small issuers through third parties or would it be different?

John D. Lowe

President, CEO & Director

Yes, Pete. So just to start, Arroweye is an entity that we had seen in the market over a number of years. If you think about who we compete against in the market broadly, there's larger players, there's smaller players. They service what I would say is a smaller, more nimble card program.

So think of fintechs who might want to test out different types of card programs and do it on the fly. Those are the types of unique solutions that we at CPI don't necessarily have. The larger players don't necessarily have. So in many cases, there are customers that we have where there's small overlap, where they might want to do a really small nimble program, and they'll go to Arroweye to do that.

So in cases where we're scaling with a customer, that customer may be coming with us. But in the cases where that customer wants to do something really nimble that we might not be able to do, they're going to Arroweye. And then there's a large portion of the market that wants those small nimble programs, think of fintechs that act as program managers, if you will, that service a number of different types of programs and think of their programs as almost like marketing tools for a number of different unique institutions. And so that's where an Arroweye comes into play. And they have technology that we don't have. And ultimately, we believe they can penetrate the market in ways that we cannot. And to a certain extent, we can offer their solutions to our customers in ways that we cannot. So it's a good complementary solution, and we believe it will generate a strong return for not only CPI, but our shareholders as well.

Peter James Heckmann

D.A. Davidson & Co., Research Division

Okay. That's great to hear. And then in terms of the EBITDA margins at Arroweye, I didn't hear, did you give maybe a time horizon for your expectation of margins moving towards the CPI average?

John D. Lowe

President, CEO & Director

I think the way we described it is they have kind of low double-digit adjusted EBITDA margins right now. Obviously, in 2025, there's a bit of integration that we need to do. So margins may be impacted this year from that. That said, we do believe we can bring their margins closer to CPI margins. We didn't give a time frame. But Jeff, do you want to comment on the accretion and...

Jeffrey A. Hochstadt

Chief Financial Officer

Yes. No, it's going to take a little bit of time. I mean one of the things we're excited about is they're smaller smaller company, we bring -- our purchasing power is much greater. So we're going to be able to bring a lot of cost of goods synergies over time. It's going to take some time, but we do feel like over the longer period, we're going to be able to get the margin near where we are with CPI.

Operator

The next question comes from Jacob Stephan from Lake Street Capital Markets.

Jacob Michael Stephan

Lake Street Capital Markets, LLC, Research Division

On the acquisition as well. Maybe just to start off, a housekeeping item, you could help us understand kind of the balance sheet moves here with the acquisition. What would you draw on the revolver versus cash on the balance sheet?

Jeffrey A. Hochstadt

Chief Financial Officer

Yes. We ended the quarter with about a little over \$30 million of cash. We drew about \$35 million from our revolver. So after this acquisition, we'll still have some cash on hand for sure, but that's really how we finance it.

Jacob Michael Stephan

Lake Street Capital Markets, LLC, Research Division

Okay. Perfect. And then maybe you could just help me understand kind of the broader portfolio application here. It sounds like this is more on the prepaid debit side. Do you see an opportunity with kind of retailers here with Arroweye and talking about those smaller run programs?

John D. Lowe

President, CEO & Director

Yes. I mean I think that's a good point. I mean, whether you're in the prepaid debit space, whether you're a retailer wanting to try out different types of branding for your customers, whether you're a fintech working with a number of programs that you want to test out with maybe a younger generation. There's a number of applications that Arroweye fits into. So again, I'd say their solution is -- the way I'd describe it is just unique to what we have and much more nimble. They refer to it as hyper personalization. So they can move on the fly, and it definitely opens up an area of the market that we don't necessarily service today.

Operator

The next question comes from Craig Irwin from ROTH Capital Partners.

Craig Irwin

ROTH Capital Partners, LLC, Research Division

A number of your shareholders have pinged us this morning asking about pricing. Is there anything you can share with us about the pricing environment right now? And is there anything competitive going on? Or do you maybe have mix issues also impacting gross margins? I know there's been some success with large issuers in the last couple of quarters, did notice the hiring in Colorado. Can you maybe just unpack this for us as far as the pricing environment and what we should think about going forward?

John D. Lowe

President, CEO & Director

Craig, let me comment on that and then ask Jeff to as well. The market in general is -- I mean it's always a competitive market. But I would say pricing is always based upon the value proposition of what you're selling into that market. The overall -- think of the inventory rebalancing that had been going on, that we're probably in the tail of. So I'd say we're back more in the normal course somewhat. And just from a volume perspective, we've grown multiple quarters in a row. So we're seeing positive events in the market that I would say create a more rational pricing environment. But Jeff, do you want to speak to the quarter and how it sits?

Jeffrey A. Hochstadt

Chief Financial Officer

Yes. I can give you a little bit more color on the gross margin. Craig, you're right. You mentioned sales mix that from time to time, we see different products going through and some of them have higher margins, some of them have a little bit lower margins. This was a quarter with a little bit lower margin for the sales mix. Also, we had a little bit higher production costs in the quarter than we normally see. So we're working on efficiency programs there that will get those production costs down over the rest of the year.

Also, we have a little bit of incremental costs just as we're getting our new facility in Indiana up and running. So that also happened a little bit in Q1. We'll see that a little bit more in the next couple of quarters as the new facility comes online. So when we look at the rest of the year in terms of our gross margin, we do think Q2, I think the gross margin is going to be pretty similar. But in the second half of the year, we do see a little bit better sales mix coming.

Like we said, I think the production costs will be driving some efficiencies there. So I think that will improve. That will be offset a little bit by continued Indiana costs with the new facility. And also, we mentioned the tariff impact of a couple of million dollars. So ultimately, on the gross margin line, we see it improving from where it was in Q2, but probably lower than what we saw last year in 2024. And that's one of the reasons why we did some cost actions on the SG&A line to kind of offset that a little bit. We talked about reducing headcount. So we did that recently. That will bring our cost structure down.

We're tightening the belt a little bit on our discretionary spend. We're still trying to invest in the areas that we want to invest in, but trying to limit hiring in certain places and discretionary spend where we can. So kind of trying to offset some of the margin -- gross margin decline that we see this year year-over-year with some SG&A improvements.

Craig Irwin

ROTH Capital Partners, LLC, Research Division

Excellent. That actually dovetails nicely to my second question, which is start-up costs for Indiana. So it did appear like you were hiring quite significantly for the facility or at least advertising for positions this last quarter. And I wanted to ask if you have actually been bringing people online and training them for a rapid start as you look to serve new customers. Can you maybe just clarify this for us? And anything quantitative that you can give us as far as employee costs or other frictional costs for the start-up of this facility and how these are likely to taper? And can you also just confirm that just a couple of weeks away, we were talking about June, that's really less than a month from now. So the benefit should start to kick in fairly soon.

John D. Lowe

President, CEO & Director

Craig, so you're right, and Jeff mentioned it a little bit. As we transition from one location to another. There is overlap in cost. There's overlap in hiring, if you will. We are hiring more people to service in a sense, the transition. And you see that in Q1. You'll continue to see that throughout the year. Jeff can probably speak to more of the quantitative side of it, but it's definitely something that we knew would impact us this year. That's part of the reason when we gave our original guidance, which we affirmed today, revenue growth and adjusted EBITDA growth are roughly the same with some of the investments that we're making this being one of them kind of eat into our spending. But ultimately, when you go to 2026 and beyond, we believe these will be accretive and strong returning investments that we're making.

Jeffrey A. Hochstadt

Chief Financial Officer

Yes, Craig, we didn't give exact numbers for the transition for Indiana. But as John said, we'll be running both facilities for a period of time just so we don't lose a step with our customers. So that will go through the end of the year. Once the new facility goes online, we'll still be running both facilities for a period of time, probably through the end of the year. But nothing specific on those costs. But like I said, we're taking some cost actions in other parts of the business. And we still feel good with our outlook of mid- to high single digits for both revenue and adjusted EBITDA.

Operator

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. Well, 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. Also, I'd like to welcome the Arroweye team to the CPI family. We're excited to have you all on board. Thank you all for joining, and we hope you have a great day.

Operator

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

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