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Compass Diversified Holdings, Inc. (CODI)

Q3 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. And welcome to Compass Diversified's Third Quarter 2020 Conference Call. Today's call is being recorded. All lines have been placed on mute. [Operator Instructions]

At this time, I would like to turn the conference over to Matt Berkowitz at The IGB Group for introductions and the reading of the Safe Harbor statement. Please go ahead, sir.

Matthew Berkowitz
Senior Account Executive, The IGB Group

Thank you. And welcome to Compass Diversified's third quarter 2020 conference call. Representing the company today are Elias Sabo, CODI's CEO; Ryan Faulkingham, CODI's CFO; and Pat Maciariello, COO of Compass Group Management. Before we begin, I would like to point out that the Q3 2020 press release, including the financial tables and non-GAAP financial measure reconciliations, are available at the Investor Relations section on the company's website at www.compassdiversified.com. The company also filed its Form 10-Q with the SEC today after the market close, which includes reconciliations of non-GAAP financial measures discussed on this call and is also available at the Investor Relations section of our website.

Please note that references to EBITDA in the following discussions refer to adjusted EBITDA as reconciled net income in the company's financial filings. The company does not provide a reconciliation of its full year expected 2020 adjusted EBITDA or 2020 payout ratio because certain significant reconciling information is not available without unreasonable efforts. Throughout this call, we will refer to Compass Diversified as CODI or as company. Now, allow me to read the following Safe Harbor statement. During this conference call, we may make certain forward-looking statements including statements with regard to the future performance of CODI and its subsidiaries. Words such as believes, expects, plans, projects, and future or similar expressions are intended to identify forward-looking statements.

These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors could cause the actual results to differ on a material basis from those projected in these forward-looking statements and some of these factors are enumerated in the risk factor discussion in the Form 10-K as filed with the SEC for the year ended December 31, 2019, and as further updated in the Forms 10-Q as filed with the SEC for the quarters ended March 31, 2020; June 30, 2020; and September 30, 2020, and as well as in other SEC filings.

In particular, the domestic and global economic environment, as currently impacted by the COVID-19 pandemic has a significant impact on our subsidiary companies. Except as required by law, CODI undertakes no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events, or otherwise.

At this time, I would like to turn the call over to Elias Sabo.

Elias J. Sabo

Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.

Good afternoon. Thank you all for your time and welcome to our third quarter earnings conference call. Before discussing our results, I would like to take a brief moment to acknowledge the continued impact of the COVID-19 pandemic. This year has been challenging in many ways for so many people, and we hope that you and your families are well in managing through this period of change. Despite the challenges brought on by the pandemic, I am pleased to report that our third quarter results substantially exceeded our expectations.

Including Marucci's results from January 1, 2019, pro forma consolidated subsidiary adjusted EBITDA of $76.9 million exceeded prior-year by 10%. This outperformance was driven by our branded consumer businesses, which produced pro forma consolidated revenue and adjusted EBITDA growth of 15% and 42%, respectively, over prior year.

Looking back on the past few months, I am incredibly proud of our team and the work we have done to position our subsidiaries for long-term success while driving value for our shareholders. Notably, we closed on the acquisition of BOA Technology, our second platform acquisition of the year. As we continue to transform our portfolio, BOA joins our lineup of market-leading branded consumer businesses including Marucci Sports, which we acquired in April. The ability to source, finance, and close these strategic acquisitions among – amid the height of the pandemic is a clear testament to our differentiated permanent capital model as compared to the traditional private equity model employed by our peers.

Throughout 2018 and 2019, while others in the industry were aggressively deploying capital, our permanent capital approach allowed us to be patient. Instead, we capitalized on favorable market conditions and opportunistically divested two of our subsidiaries and used the proceeds to repay debt and strengthen our balance sheet. Now, in 2020, the pandemic has created market dislocations, and our team has pivoted to a more aggressive acquisition strategy, while peers have struggled to access the credit markets.

Our strong results in the third quarter and year-to-date period reflect the significant advantages of our model of owning a diverse set of niche market-leading companies that serve a variety of end markets. The benefits of diversification have never been more pronounced in reducing the volatility in our financial results and the addition of BOA and Marucci only serve to further enhance that diversification and the breadth of end market served. In addition to our capital allocation accomplishments over the past couple of years, I am also proud of the significant strides we have made in enhancing our management talent and depth across our subsidiary company.

During the third quarter, we promoted Jason Frame to CEO of Ergobaby. Jason is a talented and experienced executive who has worked with CODI for many years, first, in his capacity as CFO of CamelBak and most recently as CFO of Ergobaby. Additionally, we announced that Craig Carnes would be assuming the role of CEO of The Sterno Group following Don Hinshaw's planned retirement at the end of the year. I want to thank Don for all his contributions to Sterno and CODI over the years. We look forward to continuing to work with him in his capacity as a Director of Sterno. We have the utmost respect for both Craig and Jason and are highly confident that both will succeed in their new roles.

Our push to digitize our subsidiary businesses has further enhanced our financial results. Across all of our businesses, we have been building our digital presence and, where possible, reducing our reliance on physical infrastructure. The pandemic has created a seismic shift towards digitally enabled businesses and our strong performance in 2020 is the culmination of a significant investment of time and resources over the past few years to digitally transform our subsidiaries. We remain focused on further modernizing our subsidiaries enhancing – and enhancing their digital capabilities, as we believe that increased consumer demand for online retail will last long after the pandemic has been contained.

While our results exceeded our expectations in the third quarter, our subsidiary companies continue to see the impact of the ongoing pandemic. Certain of our companies have experienced the sudden decline in revenue due to strain on their end markets, while others have experienced a large increase in demand that has caused stress throughout their supply chain. And across most of our subsidiaries, we struggle to hire additional human capital. I would like to thank each of our subsidiary management teams for their exceptional service, leadership, and dedication during these challenging times.

Now, turning to our financial results. Consolidated subsidiary pro forma revenue for the third quarter increased by 3.9% to $419 million and consolidated pro forma adjusted EBITDA increased by 10% to $77 million. Of our nine subsidiaries, six showed growth over prior year and virtually all of our companies exceeded our expectations. And although, we did not close on BOA Technology until after the third quarter, BOA also produced results that were ahead of our expectation. Management estimates that BOA produced revenue and EBITDA growth of 20% and 67% respectively during the third quarter, and on a year-to-date basis, revenue was flat and EBITDA was up 5%.

We generated $43.5 million of cash flow available for distribution and reinvestment, which we refer to as CAD, during the third quarter of 2020 as compared to $30.2 million of CAD in the third quarter of 2019.

This growth of 44% far exceeded our expectation. However, as Ryan will detail in his section, our third quarter CAD was boosted by a cash tax reversal from the second quarter at Velocity Outdoor. Even without this cash tax reversal, our CAD significantly exceeded our expectation. On a year-to-date basis, our [ph] CAD of $74.7 million (00:09:16) exceeded prior year-to-date of $74 million and covered our distribution payments to common shareholders of $68.3 million.

Turning to guidance. Our outlook for the coming months continues to change every day due to the ongoing pandemic, which means continued uncertainty and limited visibility. While continued shutdowns of certain areas of the economy could negatively impact our results more than we currently anticipate, we felt it was important to provide our shareholders and capital partners with some visibility into our expected performance.

Please note that our guidance includes both Marucci and BOA as if they were acquired on January 1, 2020. For full year 2020, we anticipate pro forma adjusted consolidated subsidiary EBITDA of between $270 million and $280 million. For comparison purposes, excluding BOA, we expect full year 2020 pro forma adjusted consolidated subsidiary EBITDA of between $240 million and $250 million, as compared to previous guidance of between $210 million and $240 million reflecting an increase of $20 million at the midpoint or an improvement of 8.8%.

We anticipate a CAD payout ratio for the year of 100% to 90%, a substantial improvement over previous guidance of 140% to 120%. Notably, we now expect to cover our annual distribution not notwithstanding the economic headwinds that exist due to the pandemic. As Ryan will detail later in his section, we are forecasting an increased amount of capital expenditures in the fourth quarter as many of our businesses have reduced their capital expenditure spend throughout the year, but now with improved performance are seeking to invest capital in areas that will strengthen their competitive positioning.

With that, I will now turn the call over to Pat.

Patrick A. Maciariello

Partner & Chief Operating Officer, Compass Diversified Holdings, Inc.

Thanks, Elias. Before I begin in our subsidiary results for the quarter which exceeded our expectations, I want to touch generally on the continued effect of the pandemic throughout our subsidiary companies. Similar to last quarter, our branded consumer businesses continued to benefit from increased demand in Outdoor categories and as a result, experienced strong sales and earnings growth.

Our niche industrial businesses also exceeded our expectations as a group, though sales and earnings continued to face headwinds predominantly due to work stoppages and slowdowns in the aerospace and hospitality industries.

Now on to our subsidiary results for the quarter. I'll begin with our niche industrial businesses. For the third quarter of 2020, revenues declined by 8.1% and EBITDA decreased by 18.3% over the comparable quarter in 2019. For the year-to-date period, revenues declined by 9.1% and EBITDA decreased by 15.1% over the comparable period in 2019.

Advanced Circuits continued its steady performance with EBITDA in the quarter growing 2.3% over prior year. The growth CapEx investment we made last year in a new facility in Chandler, Arizona continued to provide benefits as growth in this advanced manufacturing facility offset some weakness in sales of smaller orders typically associated with engineering students and hobbyists driven partially by school closures.

Arnold Magnetic EBITDA declined in the quarter from $4.4 million last year to $1.3 million in the current quarter. Arnold's performance was impacted partially by severance and related charges as the company works to adjust its workforce to appropriately respond to the decreases in demand in its aerospace and oil and gas end markets. As we touched on last quarter, we believe the longer-term prospects for Arnold remained strong. However, some of the company's end markets will likely face continued challenges due to the effects of the pandemic, and unlikely to rebound fully in the near term.

Foam Fabricators grew by 15.1% in the third quarter. Though the company benefited from the add-on acquisition of Polyfoam Corporation at the beginning of the quarter, Foam Fabricators also experienced improved performance in its core business in both earnings and EPS pounds processed.

The Sterno Group's EBITDA on the third quarter was down 27% from the year-ago period. Sterno performed better than our expectations in the quarter as the company's consumer business continued to experience elevated demand for its line of wax and essential oil products. Core catering sales of chafing fuel and related products remain challenged. We expect this segment to remain depressed for some time as large gatherings continue to be discouraged.

Sterno continued to develop its full line of hand sanitizer products. While sales of these newly introduced items in the third quarter declined sequentially due to significant inventory of product in the supply chain, we remain encouraged by the prospects of this new market for Sterno.

Now, turning to our branded consumer businesses, which continued to benefit from ongoing consumer demand and Outdoor categories. Our results are presented as if we own Marucci from January 1, 2019. However, they do not include the results of BOA, which was acquired following the end of the quarter. For the quarter of 2020, pro forma revenues and adjusted EBITDA for these businesses increased by 15.2% and 42.3% respectively over the comparable quarter in 2019, significantly exceeding our expectations.

For the year-to-date period, pro forma revenues and adjusted EBITDA increased by 7.8% and 17.7% respectively over the comparable period in 2019. Ergobaby's EBITDA was down 17% in the quarter from the year-ago period. Several large Asian distributor partners reduced their third quarter and fourth quarter orders due to excess inventory on hand following pandemic-related shutdowns in the second quarter which negatively impacted Ergobaby's results.

End-market demand in the most impacted Asian geographies recovered somewhat in the third quarter but they largely remained below year-ago levels. Reduced distributor orders will remain a headwind for the remainder of the year negatively impacting the company's fourth quarter performance. However, we are encouraged by several planned new product introductions launching in the fourth quarter, and we're optimistic about the company's outlook in 2021.

Liberty Safe's EBITDA was up an impressive 96% in the third quarter from the year-ago period, significantly above our expectations. End market demand online and at retailers remained strong for Liberty's products. And much of the company's production capacity remains filled into the first quarter of 2021. The management team and employees at Liberty continue to perform admirably as they work through the dual challenges of COVID-19 and significant increases in demand.

Marucci's revenue in the third quarter increased by 31% and EBITDA that increased 81%, as compared to the prior year period, significantly surpassing our expectations. The increase in revenues and profitability was driven by the launch of Marucci's New CAT9 line of bats and the gradual return of baseball during the quarter. We are pleased by the success of the launch and believe it affirms the strength of the Marucci brand and the quality of their products.

As you may know, professional baseball resumed in the United States and had a successful regular and postseason. Youth baseball has returned at various levels in portions of the United States, though participation levels are not nearing those of 2019 and may not in the short-term.

Velocity Outdoor's EBITDA increased substantially in the third quarter, up 77% from the year-ago period. Velocity's performance was better than expected and continued consumer interest in Outdoor activity drove added demand for all the company's products. Despite challenges placed on the supply chain and production capacity, management and the company's employees continued to deftly handle heightened levels of demand.

Despite Velocity's efforts, retail channels remain low on inventory, and we are working diligently to keep our wholesale partners in stock with adequate inventory levels.

Finally, 5.11's EBITDA was up 24% in the third quarter from the year ago period and has increased 15% on a year-to-date basis. The company benefited from increased margins as a greater portion of its revenue was driven by [ph] DTC channels (00:17:54).

While traffic and performance in the company's retail stores continue to face the impacts of COVID-19 operating restrictions, 5.11's e-commerce business continues to exceed our expectations. We believe that numerous macro trends are impacting the 5.11 consumer brand positively and that the company has even greater opportunities ahead.

With that, I will turn the call over to Ryan to add his comments on our financial results.

Ryan J. Faulkingham

Executive Vice President, Chief Financial Officer & Co-Compliance Officer, Compass Diversified Holdings, Inc.

Thank you, Pat. Before I discuss our consolidated financial results for the third quarter of 2020, I want to highlight our third quarter distributions that were recently paid to shareholders. On October 22, 2020, we paid shareholders a cash distribution of $0.36 per common share, representing a current yield of approximately 8.4%.

A few notable highlights of our most recent common distribution. One, this marks our 58th quarter in a row that we have paid a distribution. And since our 2006 IPO date, we have paid more than $20 per share in cumulative distributions. Additionally, on Friday of this week, we will pay cash distributions of approximately $0.45 per share on our 7.25% Series A preferred shares and approximately $0.49 per share on our 7.875% Series B and Series C preferred shares. All three preferred distributions cover the period from and including July 30, 2020, up to but excluding October 30, 2020.

Moving to our consolidated financial results for the quarter ended September 30, 2020, I will limit my comments largely to the overall results for our company since the individual subsidiary results are detailed in our Form 10-Q that was filed with the SEC earlier today. On a consolidated basis, revenue for the quarter ended September 30, 2020, was $418.9 million, up 7.9% compared to $388.3 million for the prior-year period. This year-over-year increase primarily reflects strong sales growth at our branded consumer subsidiaries, Velocity Outdoor and Liberty, offset by Sterno and Arnold businesses, most impacted by the COVID-19 pandemic.

Consolidated net income for the quarter ended September 30, 2020, was $20.9 million. Consolidated net loss for the prior year's third quarter was $26.5 million and included an impairment charge at Velocity Outdoor of $33.4 million. CAD for the quarter ended September 30, 2020, was $43.5 million, up 44% from $30.2 million in the prior-year period. Our CAD that we generated during the quarter was significantly above our expectations, primarily due to our strong third quarter EBITDA increase as compared to prior year.

As Elias highlighted, the negative cash tax impact we had in the second quarter at Velocity Outdoor reversed in the third quarter. Thus, we had no cash taxes at the consolidated level, further contributing to a strong CAD performance. As we've mentioned many times in the past, our cash taxes are extremely difficult to predict quarter to quarter; however, we are able to do so more easily on an annual basis.

Other factors impacting our CAD in the third quarter compared to the prior year include slightly higher CapEx spend and higher preferred share distributions as a result of our Series C issuance in November of 2019. As of September 30, 2020, we had over $175 million in cash, approximately $600 million available on our revolver and our leverage was below 2 times. As you are aware, we closed on the BOA acquisition on October 16. To fund this transaction, we used cash on hand, a $300 million draw on our revolver and an investment by BOA minority shareholders of $61.5 million.

Pro forma for the BOA funding, our balance sheet remains strong with our leverage at approximately 3.2 times. Our revolver availability is approximately $300 million today, providing substantial liquidity. And as previously communicated, we have the ability to upsize our revolver capacity by an additional $250 million. We stand ready and able to provide our subsidiaries the financial support they need, make distributions to our preferred and common shareholders, as well as move on compelling investment opportunities in this dislocated market as they present themselves.

Turning now to capital expenditures, during the third quarter of 2020, we incurred $3.8 million of maintenance CapEx of our existing businesses compared to $3.3 million in the prior-year period. During the third quarter of 2020, we continued to invest growth capital, spending $4.1 million in the quarter, primarily related to 5.11's long-term growth objectives. Growth CapEx in the prior year quarter was $4.3 million.

Turning to our expectations for 2020, as a reminder, our quarterly operating and cash flow results can vary materially based on factors such as the timing of shipments of large orders or the timing of certain investments made before or after quarter end. Elias provided adjusted EBITDA guidance and our payout ratio expectations for the full year of 2020. I'd like to now provide guidance on capital expenditures and cash taxes.

For maintenance CapEx, our estimate of spend for the full year of 2020, including Marucci and BOA from the date of acquisition, is between $15 million and $18 million. As Elias mentioned, our fourth quarter CapEx spend is forecasted to be higher than original expectations. Many of our businesses are experiencing improved performance and are, therefore, investing capital in areas that will strengthen their competitive positioning. For growth CapEx, our estimate of spend for the full year of 2020 is between $13 million and $15 million, primarily at 5.11.

For 2020 cash taxes, we expect full year cash taxes to be between 7.5% to 8.5% of our subsidiaries' total adjusted EBITDA. This cash taxes percentage range is slightly higher than previous guidance given the outperformance at certain of our subsidiaries.

Keep in mind, this percentage should be applied to full year 2020 total adjusted EBITDA and not quarterly. As we experienced in Q2 and Q3 with Velocity Outdoor, our cash taxes as a percentage of EBITDA can vary significantly quarter to quarter.

With that, I will now turn the call back over to Elias.

Elias J. Sabo

Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.

Thank you, Ryan. I'd like to close by briefly discussing M&A activity and our go-forward growth strategy. As I mentioned earlier, we took steps in 2019 to prepare for the unexpected. Those decisions and our unique permanent capital structure have positioned us to not only weather the storm, but also proactively execute on our growth strategy. We continue to have the balance sheet strength to support our companies as they operate in these highly unusual times.

Our subsidiaries are leaders in their respective industries and are poised to gain additional market share in the months and years to come. We will continue to seek both platform and add-on acquisitions as we believe there are compelling opportunities for us to generate long-term shareholder value during market dislocations like we are currently experiencing.

In addition, we will continue to invest in and enhance our subsidiary companies' competitive positioning, which includes supporting them as they build and grow their digital transformation strategy. Our differentiated strategy has set CODI apart for more than a decade and it remains consistent as we navigate the uncertainty ahead and position our diverse group of subsidiary companies for long-term success. We are intensely focused on executing our proven and disciplined acquisition strategy, improving the operating performance of our company, opportunistically divesting, enhancing our commitment to ESG initiatives across our portfolio and creating long-term shareholder value.

With that, operator, please open up the lines for Q&A.

QUESTION AND ANSWER SECTION

Operator: Your first question is from the line of Larry Solow.

Lawrence S. Solow
Analyst, CJS Securities, Inc.

Q

Great. Good afternoon, guys. Congrats on a very nice quarter. Just a broad-brush question and maybe, I realize you guys are in a lot different industries, but clearly, you exited Q2 with a lot of momentum and some pent-up demand. As you exited Q3, it seems like a lot of industries are coming back, there are some exceptions obviously, hotel business, catering itself not coming back anytime soon, but it seems like a lot of things are coming back or normalizing even with COVID still out there, obviously. As you compare, do you feel like – how do you feel like exiting Q3 versus Q2? Do you feel even better than you did, about the same? Any way to sort of answer that in a broad-brush?

Elias J. Sabo
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.

A

Yeah, Larry, it's Elias. And thank you for the question and good afternoon. I would say, you're right, in Q2, we exited feeling pretty confident. Clearly, the caveat to what I'm about to say is the pandemic creates such incredible uncertainty that, it's really hard to give guidance and at any one day, you may feel different than you do the next day. I'd say, today, we woke up to the markets down, whatever, 900 points and France going into a shutdown and Germany, I guess, having modified shutdown. So, there's clearly impacts that are outside of our control. That being said, I would say we feel similar to how we felt at the end of Q2. I mean, the businesses, largely, are running really well. The same trends that existed coming out of Q2 are really remaining intact in Q3.

Outdoor continues to be a category that is being benefited significantly. Our industrial businesses that cater to certain end markets, like food service and aerospace, Sterno and Arnold in particular, are finding the same struggles. So, I would say those trends remain in path.

Now, clearly, from quarter to quarter, Larry, there can be unique things that happen. For example, we have the CAT9 launch at Marucci. That's going to be a net positive when you have a new launch of something that is a two-year plan launch, it's a two-year cycle. So, we don't expect that kind of result to happen in the fourth quarter. But when you're talking about large trends, I would say the trends that were here before continue to exist. I think we're getting a little bit better at managing some of our supply chain issues where demand is suddenly boosted.

But we didn't want to call out the continuation of the problem of hiring additional human capital talent. That problem continues, especially at some of the manufacturing job level. And so, that does put some capacity constraints on us the same way that it did after the second quarter.

Lawrence S. Solow
Analyst, CJS Securities, Inc.

Q

Okay. Great. Appreciate that color. Just a couple on the segment level, the holding level, just at 5.11. Obviously, you guys did a [indiscernible] (00:29:32) kept sales flat in the quarter and obviously, the [indiscernible] (00:29:35) general apparel industry [indiscernible] (00:29:37) still down significantly. EBITDA actually grew 25%. And I'm sure part of that is a shift to the online presence. But just maybe you can discuss, and I realize it's somewhat small numbers, the $1 million is 15% of growth but it's – but, still, pretty commendable to grow EBITDA 25% on a flat sales level. Any color on that? More color on that?

Patrick A. Maciariello
Partner & Chief Operating Officer, Compass Diversified Holdings, Inc.

A

Yes. This is Pat. I mean, I'd say you hit the nail on the head with the – you hit the nail on the head as you talked about the increase in margins. That was a big driver of the growth. Honestly, our companies are doing a good job controlling costs in COVID and in 5.11 [ph] at this point (00:30:23). Certain of those costs as it relates to travel and entertainment are limited, and that has a net benefit, and it's a kind of culmination of those things, I'd say, Larry, if that makes sense.

Lawrence S. Solow
Analyst, CJS Securities, Inc.

Q

Yeah. No, absolutely. And just on the new store openings, I know you mentioned – Ryan mentioned that the growth capital, most of it going into 5.11. I don't know if you want to give specific numbers, but has that sort of been [ph] ticking up since I know in Q2 sort of, you obviously stopped this (00:30:47) temporarily. And have you found more opportunities with sort of the real estate environment not doing so well?

Ryan J. Faulkingham
Executive Vice President, Chief Financial Officer & Co-Compliance Officer, Compass Diversified Holdings, Inc.

A

No, we have and I'm actually looking for the exact number because I don't want to misquote it, and I don't have it here. But we have and we'll be a little bit north of 70 stores. 73 stores is our sort of view towards at the end of 2020 versus sort of 61 in 2019. So, we're finding opportunistically good deals and we've slowed down our growth a little bit this year, obviously, as we kind of halted it for a few months there. But, opportunistically, we're looking for good deals and continue to grow and we're getting a – we remain – the ROI and our return on these investments continued to be very high.

Elias J. Sabo
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.

A

Yeah. And, Larry, I would also just mention that in the quarter and expect that going forward, continues to be a lot of technology investment that is growth CapEx, we categorize as growth CapEx. Our online business, we've said, is kind of growing rapidly [indiscernible] (00:31:47) doubling for a big part of the year and kind of continues with that trend. And so, to support that, you really do need to create more robust online – more robust technology capabilities.

But I would say and even broader than that, part of it is supporting online, but part of it is supporting omni-channel, the ability to ship from store. I think we're now up to – and this is a small number, but we went from zero to three stores that we're able to ship from and we expect to be somewhere north of 10 by the end of the year. So, we're making progress against some of those initiatives. It does take a little bit of time, but you have to invest in technology in advance of being able to do this. And that really relieves some of the distribution and supply constraint problems that you can have from the main facility. It creates a lot of efficiency in the system. So, these are good long-term growth initiatives that we continue to put in. I'd say even beyond long term, they're kind of near term and intermediate-term growth initiatives. But we are making a significant amount of technology spend at 5.11 in particular that is part of that growth CapEx in Q3.

Lawrence S. Solow
Analyst, CJS Securities, Inc.
Q

Got it. Great. I appreciate it. Thanks again.

Operator: Your next question is from the line of Kyle Joseph.

Kyle Joseph
Analyst, Jefferies LLC
Q

Hey. Good afternoon, guys. Congratulations on another good quarter and thanks for taking my questions. Ryan, just from a modeling perspective, and I know it sounds like CAD won't be impacted by the tax impact you talked about in the quarter, and it sounds like it was really essentially moving a part of CAD from the second quarter to the third quarter. But could you kind of – could you quantify the benefit in the third quarter just so we can kind of get a framework for what the run rate CAD would have been?

Ryan J. Faulkingham
Executive Vice President, Chief Financial Officer & Co-Compliance Officer, Compass Diversified Holdings, Inc.
A

Yeah, sure. Sure. So, rough – I'll give you kind of rough numbers but, in the second quarter, our cash taxes were higher, which negatively affects CAD by about $6.5 million. That – and then in the third quarter, that reversed, but not the full amount. And, therefore, we had a benefit to CAD of roughly $5 million.

So, when you think about it on a year-to-date basis, the cash taxes at Velocity are appropriate given its taxable income and, on a full-year basis, it will, too. It was the nuance of GAAP that created that large swing because they – Velocity has massively outperformed their budget. Is that helpful?

Kyle Joseph
Analyst, Jefferies LLC
Q

That's perfect. Exactly what I need and, yeah, to give segue to my next. So, on Velocity Outdoor, I think in your prepared remarks, you talked about last year, at this point, you have taken an impairment charge on the business, ad to your point, it's massively outperforming their budget. So, what's really driven the recovery there? Is it COVID? Is it some of the management changes you guys made? And give us the outlook for the sustainability of that recovery.

Ryan J. Faulkingham
Executive Vice President, Chief Financial Officer & Co-Compliance Officer, Compass Diversified Holdings, Inc.
A

Yeah. So, I think, Kyle, the – clearly, the management changes were essential to the performance improvement that we've had. The team that we brought in here is performing at an exceptional level. And I don't want to dismiss the challenges that happen when demand ramps up as quickly as it has. The amount of challenges that our team has, not only at Velocity, but at other of our subsidiaries, 5.11, Liberty, it really is a lot. You're talking about stressing your supply chain and stressing your human capital. A lot of overtime hours, trying to hire and bring, onboard new people. So, there are a lot of challenges that this management team has been really adept at managing through. So, I would, first and foremost, say without them in the seat, I don't know we would performed nearly [ph] this (00:35:53) well.

Now, the backdrop is, there is just a large increase in the amount of outdoor activity that is happening, and a lot of people that have come back into the sport. And so, we think that is more – is it all sustainable? I don't know. I mean, no one has a crystal ball. I would say we think it's more sustainable than not. I think we also are comparing to a period where results were very depressed. And so, we had two of our retail partners merge together. That created incredible disruption for us as a supplier to them over 2018 and mostly over 2019, so that was a big issue. So now, with that largely behind us, we would have expected to see some type of pickup that was pretty substantial.

I would say on top of that, we had a real effort to start to build a direct-to-consumer practice, which has lacked under prior leadership, and those efforts are really gaining traction with very strong margins. And so, this is sort of the perfect time for us to be able to launch in there. So, it's a culmination of a lot of things that are driving the result. I would say yes. End demand is up. But I think our business is performing beyond just end demand being up because of some of those – whether it be market changes, kind of our customers no longer having the headwind of merging together, things of that that may have been one time more distorting negatively in 2019. So, we think this is more sustainable. And, going forward in the fourth quarter, as Pat had mentioned, inventory in our retail channel partners is very low right now. In fact, if anything, it could be causing us some lost sales because we just don't have adequate product on the shelves. But I think that also bodes well for our performance as we look into fourth quarter and into 2021 just bringing our inventory levels back up to kind of normal levels and capturing sales that we may be missing right now.

Kyle Joseph
Analyst, Jefferies LLC

Q

Got it. That's very helpful. And then one last one for me really just trying to gauge your appetite for future acquisitions, whether they be platform or add-on and sort of two parts to this question. First, in terms of your balance sheet pro forma, the BOA's closing it sounds like leverage is around the 3.2 times area. And then also in consideration of competition, I think it's fantastic you guys were able to complete two platform acquisitions when markets were really disrupted between March and today. But from everything, we track and we follow in terms of sponsor activity, it seems like things are normalizing. So I guess, first, in terms of your own balance sheet but also in terms of what seems to be a normalizing sponsor market out there, your appetite for acquisitions from here?

Elias J. Sabo
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.

A

Yes. I'm going to let Ryan speak to our balance sheet, which we feel very comfortable with and still has capacity. But I'll let him speak to that. Let me address your second question, which is the sponsor activity and what we're seeing. We were really quick to move and have the balance sheet strength and capital market access, as you guys know, and we were able to close on Marucci and BOA. And I would say that was when the markets were most disrupted.

I think it depends, Kyle, where you're looking right now. So, there's certain segments of the M&A markets that are coming back and are coming back with real strength. And then there are certain areas of them that continue to stay really depressed. And so, I think it depends on where you are in the economy and how impacted your results were. Whether or not you're able to attract capital, I think it depends on how big you are, how differentiated. So, there's a lot of qualitative factors that are out there right now. But your holistic statement of private equity is starting to become more active. And as a result of that, as our competitive advantage somewhat is dissipating, I would say the answer to that is yes.

And so, we feel good. We put $700 million roughly, whatever, $654 million of capital to work so far this year. We've achieved what our goals are. I think if we were able to find some add-on acquisitions to the nine platforms we have right now, that would be good, accretive, value-enhancing ways for us to deploy capital. I would say what we're seeing trading in the market right now in terms of new platforms doesn't seem overly interesting to us. So, we don't have, I would say a pipeline that is quite as robust as what it was earlier in the year with as high a quality of opportunities. But things can change pretty quickly.

And again, I'll go back to what I said when Larry asked his first question. The pandemic is creating high – heightened uncertainty, and so what we may have heard over the last few weeks when people felt a vaccine was close, or therapeutics were close or the economy was going to stay open globally and start to regain the scene, that could actually change really quickly like it did today when we heard some European economies already starting to close down. You know, Chicago just had all indoor dining closed. So, we are in a really fluid market right now and that definitely impacts M&A right, confidence of buyers impacts that dramatically.

So, I think you're right [indiscernible] (00:41:49) is picking up. We forecast that private equity in 2021 will continue to increase in its activity level. And we'll have to adjust and find good opportunities to deploy capital against that backdrop.

Ryan, do you want to speak a little to our balance sheet capacity?

Ryan J. Faulkingham A
Executive Vice President, Chief Financial Officer & Co-Compliance Officer, Compass Diversified Holdings, Inc.

Yes. Sure. Thanks so much. So, as I said in my remarks, Kyle, and as you highlighted, we're roughly 3.2 times leveraged. You know, as a financial policy, we communicated last year that [indiscernible] (00:42:22) is a comfortable area to be. We're obviously below that. So, feel very good about our leverage. Our performance continues to improve. So, I think about that denominator as continuing to decline which should only help our leverage levels.

And in terms of liquidity, we've got $300 million available on the revolver. We still have the ability to upside that by $250 million. So, plenty of – plenty of liquidity to move on transactions whether they be platform or add-on acquisitions. So, feel like we're in a great position balance sheet wise.

Kyle Joseph Q
Analyst, Jefferies LLC

Got it. Thank you very much for taking all my questions.

Elias J. Sabo A
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.

Thank you, Kyle.

Ryan J. Faulkingham A
Executive Vice President, Chief Financial Officer & Co-Compliance Officer, Compass Diversified Holdings, Inc.

Thanks, Kyle.

Operator: Your next question is from the line of Matt Koranda.

Matthew Koranda
Analyst, Roth Capital
Q

Hey, guys. Thanks.

Matthew Koranda
Analyst, Roth Capital
Q

Hey, Matt.

Matthew Koranda
Analyst, Roth Capital
Q

I just wanted to cover a few segment questions. So first on Marucci. Just wanted some help with the drivers of strength there in the quarter. I know you guys mentioned that launch, which obviously was probably pretty helpful, but just was there any pent-up demand or like a shift from 2Q into 3Q? I know there's probably quite a bit of seasonality in the business. And we probably shouldn't pull forward sort of 28% EBITDA margins into the off-season, but just wanted to get a sense for the drivers of strength and then how we should sort of be modeling sort of revenue cadence and seasonality in that business going forward in the 4Q and next year?

Patrick A. Maciariello
Partner & Chief Operating Officer, Compass Diversified Holdings, Inc.
A

Yes. I mean, COVID is changing a lot of the seasonality, right. And I would say we're not 100% sure on how the seasonality will move on this. I would say, was there a little bit of shift from you know Q2 into Q3? Maybe a little. But really, the CAT9 launch exceeded our expectations. The market reception to it was very positive. And that was one of the drivers. Obviously, we're not going to repeat a launch of that size this quarter but that was one of the drivers. Elias, do you have something to say?

Elias J. Sabo
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.
A

Yes. Matt, I'll just say one thing about Marucci because I think it – when we acquired this business, it was at the depths of the pandemic. And prior to that, this was a business that was growing north of 20% annually on the revenue line. And we know that it's massively faster than what the market was growing. And then everything shut down in youth sports and in baseball and Marucci wasn't spared of that. And I think there were some real concerns in Q2, but what we had looked at and what we saw there was an extraordinary brand that had a lot of authenticity from the number of Major League Baseball players that were swinging their bats and how that translated into the youth sport category and the adoption.

And I think what Q3 has proven more so to us, and as you mentioned, could there be a little bit of seasonal shift here or there? Yes. But I would say against the backdrop with the fact that youth sports hasn't fully reopened, right. In California, we're not even getting travel baseball anymore which is the category where the company goes into.

So, this is a company that is a disruptor in its industry. It is an awesome brand. It is an exceptional management team. It's disrupting the sales channels by which it was able to deliver its product, and that manifested in an incredibly accessible product launch, really the best in the company's history despite this backdrop. And so, will things shift a little bit here and there? Yes. The pandemic is going to do that, [indiscernible] (45:55) really weird seasonality 2020, probably in 2021.

But I think what we'd like to – the message out of this is the things that we saw in this business prior to the pandemic and which gave us the confidence to close this when we were right in the depths of the pandemic and the entire economy was shut down really shined through in Q3. And we couldn't be more excited to own this brand and what we believe is its future potential.

Matthew Koranda
Analyst, Roth Capital

Q

Makes a lot of sense. Thanks for that. And then just one follow-up on Marucci as well. And obviously you guys have a lot of institutional knowledge there on building an omni-channel business in 5.11, what learnings can you take from 5.11 and apply to Marucci in terms of the omni-channel and more of a DTC approach at Marucci?

Elias J. Sabo
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.

A

I would say and [indiscernible] (00:46:47) any comments, but they're ahead of where 5.11 was when we purchased 5.11 as a percentage of sales online kind of as they go to market online. They've actually done a good job and we're just working to – not surprisingly and we're just working to support them and augment them. We will be making an investment and it's not the scale of the 5.11 investments, but we will be making an investment late this year and early next year in some additional IT infrastructure to help them with that. [indiscernible] (00:47:15) do you have any other comments on that from a...

A

Yes. The only other thing I'd add is a couple of other aspects of direct-to-consumer or in addition to websites that they have a nice business and a rapidly growing business and the team sales and they have what they call locker room which is a direct-to-consumer to teams. And then also small part of the business but I think has some exciting opportunities what they call clubhouse which is kind of a combination, batting cage, but also retail experience which is mostly on a franchise basis. But those are the other components of DTC that we're excited about and we think adds nice growth opportunity.

Matthew Koranda
Analyst, Roth Capital

Q

Very helpful. And then just – if we can shift gears over to BOA. I wanted to kind of cover, one, I mean I know it hasn't been that long, but how has the onboarding process been since the close? And then you guys referenced a really strong third quarter at BOA which obviously isn't included in these results here. But wanted to get a sense for the drivers of the 20% revenue growth and the 67-I think percent EBITDA growth that you guys referenced at BOA. I mean very strong pull-through. What's creating that margin expansion if you will, and the pull-through that they're getting?

Ryan J. Faulkingham
Executive Vice President, Chief Financial Officer & Co-Compliance Officer, Compass Diversified Holdings, Inc.

A

Yes. We don't – I want to be clear. We expect this business to grow and we have a good view of the adjacencies that are both close and the ones that are a little bit further away over the next several years and we're confident that the business will be a strong grower for us. There is a lumpiness to the business. However, quarter to quarter, month to month that drives some of that, and that kind of drove Q3 over Q3 last year. You might see that in Q1 going – hopefully, it won't be the reversal of that, but you'll see that in Q4, just some lumpiness. But the long-term trends, the trends we see in bookings, the trends we see in platforms that we're on and in products that we're on in the market continue to be very positive. So, that's just some lumpiness, but, again, a good solid growth, consistent with the multiple we paid for it, is expected and continues to be expected.

As far as the onboarding, you're right. It is relatively new into the deal. But these are great people, and this is a great team. And their positioning is just as kind of we thought it was in diligence. And we're all getting to know each other and so far, so good.

Matthew Koranda
Analyst, Roth Capital
Q

Great. And then, just one more, if I can sink one in really quickly, guys. Sorry for some many questions. But on 5.11, I'm curious just heading into holiday and winter, there's been a lot of, I guess, industry commentary out there saying that outerwear and winter sports products are doing well. I know these guys aren't squarely in that category, but I was just curious to get your sense heading into 4Q sort of if they see a lift from sort of increasing outerwear trends and adoption there. And what are the margin implications there and that type of scenario?

Elias J. Sabo
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.
A

I can't point you to a specific product. I know we have some shoes that are coming out that are – that people – and some boots that people are very excited about. I can't point to a specific outerwear product off the top of my head. I do think 5.11 will continue to perform well in Q4. And, I guess, I wouldn't – whatever margins you have in the model, I wouldn't necessarily shift them because of a push to outerwear or anything like that.

Matthew Koranda
Analyst, Roth Capital
Q

Got you. Okay, guys. Thanks a lot. I'll jump back in queue.

Elias J. Sabo
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.
A

You bet.

Operator: Your next question is from the line of Robert Dodd with Raymond James.

Robert Dodd
Analyst, Raymond James & Associates, Inc.
Q

Hi, guys. Congratulations on the whole – on the quarter. Pretty good is a bit of an understatement. On your guidance, if I can, I mean, you've talked a lot about uncertainty. The full year guidance for EBITDA that you've narrowed the range pretty considerably, now to $10 million range, only one quarter left to go, obviously, the last quarter was $30 million range with two quarters left to go. So I mean, that – is there anything to be read in there in either your confidence in your ability to predict how these businesses are going to do over the fourth quarter kind of Christmas holiday season, et cetera? Or, maybe but sound of it, with Velocity and Liberty, the revenue might be locked already. I mean, you've – you are fully booked – you're just trying to fill the supply chains back up. So, can you give us any color on the driver for why that range narrowed? And what that says about the confidence about predictability?

Elias J. Sabo
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.

A

Yeah. I think, Robert, the – and this is Elias – the – we did bring down the range, part of the range coming – the narrowness of the range is just we have only one versus two quarters, right? So, mathematically, that should narrow somewhat. We even brought it in a little bit more than that. I think...

Robert Dodd
Analyst, Raymond James & Associates, Inc.

Q

Yeah.

Elias J. Sabo
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.

A

...your observation that. In some certain of our businesses, we have revenue, mostly booked in the fourth quarter and maybe even beyond that helps to get, a better indication of, where we're going to be running. So, I think, when we looked at everything, we just felt more comfortable that we were able to bring it down, that range down. I don't know that it necessarily means that there's any less uncertainty out there because uncertainty is unfortunately high given that governments are making decisions that we have no control over regarding the reopening. But I would say, just, in general, the other thing is we've seen how our companies are able to perform within a environment that has significant restrictions imposed on it.

And, we talked about digital transformation in our companies. I think it has been lost over the years how much we've invested in both time and capital in enabling our companies to be able to conduct digital business. It may sound crazy, but a company like Advanced Circuits, there obviously have physical presence to produce the products, but virtually everything they do on the front-end is done in an online capacity, right?

And you go to someone like Liberty and you'd say how do you deliver a 2,000-pound safe online in the fastest part of their growth by – and I'm not talking about little numbers, by like order of magnitude, the fastest part of their growth, is in online deliveries and how they've been able to manage through that. Just because it's a tough challenge doesn't mean that our companies don't have to solve it. And so, I think, as we've been able to get more comfort with the way that our companies are able to operate in this environment and with a belief that now we're through October pretty much and the operating environment isn't changing or hasn't yet changed. And we'll see in November and December. I think we just have a little bit more confidence, but I would say, the decisions that can be made around COVID, which are outside of our control, continue to be an overhang and that's likely been factored in or not likely, that has been factored into the low-end of our range.

Robert Dodd
Analyst, Raymond James & Associates, Inc.

Q

Got it. I appreciate that color. Thank you. On – another one, on kind of leverage, right? So, 3.2 is yeah, not the high-end of the ratio, even the comfort level as Ryan said at 3.5. But let say, it probably means your maybe one solid add-on acquisition away from being at the midpoint of the range or rather being at your kind of target, 3.5. What would you say your – if the M&A market does continue to open up? If you see some opportunities on the add-on side, how high would you be willing to go in the short term, short term is relative?

And then tied to that, what would your – how would you like your tools for – if you do go above 3.5, bringing it down, obviously, the preferred has been one of the tools. Historically, you've also sold businesses and, bluntly the ROI and your branded consumer is much higher than the ROI right now in your industrials? So, would some of those be on the block? Or would there be something else that you'd consider maybe even just pausing and kind of growing EBITDA into the leverage? Or can you rank this kind of questions for me? How – would the potential that leverage could go meaningfully hot? And how you would address that if it were to happen? Not that it's a bad thing, it's just a question.

Elias J. Sabo
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.

A

Yeah. And I think, Robert, we try to keep in mind where we are in a cycle with respect to our leverage and what our target leverage is. And I think when we mentioned 3.5 as being target leverage, that's a good number that I would call a good mid-cycle number for us. I think we all feel we probably are closer to a trough right now in earnings than we are at a peak given where, kind of this cycle and how it's played out. So, I think that right now, just naturally, we would have a slightly, a higher propensity to take on more leverage and maybe go above midpoint. We have been up to 4 times at one point in our history, and we were later in a cycle. Now, I would tell you that we didn't feel overly comfortable and we moved pretty quickly to deleverage. But, you know, Ryan made a great point earlier, which is the denominator is growing, and we expect 2021 to show some solid growth.

Again, we can't predict what's going to happen with the pandemic. But assuming that we start to get more containment of the pandemic, there's nothing that would suggest that our earnings aren't growing. And as we talked about in our presentation around the BOA transaction, the businesses we acquired this year, in BOA and Marucci, have been additive to our growth profile. So, I think, as we've been able to add more growth and as we have more confidence, that leverage will be coming down organically with growth and EBITDA, it gives us more confidence in potentially going above 3.5 times. Now, would we go into the 4s? I don't think so. That's not a comfortable zone for us.

But, if we were in the, kind of mid-to high-3s, I think, given the growth that we're seeing in EBITDA and the fact that we now are creating, I mean – and, what I think is miraculous is the fact that we're in a pandemic and we're going through something we've never experienced before. And yet, we've now guided to be covering our distribution. So, we're not using capital to support what our distribution is. And with growth next year, clearly, that should only further to enhance our cash flow production. And so, those factors lead me to be a little bit more confident in being able to bring up, kind of our leverage to facilitate, a couple of add-ons and maybe a meaningful size one. To the extent we were to deleverage and look for more capital because we saw opportunities out there, I think – and it's hard for us to rank order these, but I think you hit on them.

I mean, it goes to sale of businesses. And even though we are right now where we are in the cycle, the truth is, everything is available for sale. It's all about a matter of price. So, if we're able to yield a value that we like in our companies, we will divest them, and we've shown a willingness to do that in the past. Preferred has been a great source of non-dilutive capital to us. I would tell you definitively with a $17 stock common is a part of that in that something went horrifically wrong in the economy and earnings were falling apart, which we don't foresee. But we feel we are pretty significantly undervalued right now given the results that we've put up. And so, I think our common stock would have to appreciate pretty dramatically for us to think of that as a tool to use. So, really, as we think of levers to pull, it would be much more either on a divestiture or on issuance of preferred.

Ryan, anything to add?

Ryan J. Faulkingham
Executive Vice President, Chief Financial Officer & Co-Compliance Officer, Compass Diversified Holdings, Inc.

A

I think you hit on everything there, Elias. I think all those points are spot on, so I've got nothing else. Thank you.

Robert Dodd
Analyst, Raymond James & Associates, Inc.

Q

Okay. I appreciate it. And I really appreciate the color, Elias. Thank you. And congratulations...

Elias J. Sabo
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.

A

Thanks, Robert.

Robert Dodd
Analyst, Raymond James & Associates, Inc.

Q

...on covering the dividend this year's trying time.

Elias J. Sabo
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.

A

Thank you. We're very proud of that.

Operator: Your last question is Derek Hewett with Bank of America.

Derek Hewett
Analyst, BofA Securities, Inc.

Q

Good afternoon, everyone. And I reiterate kind of congrats on a good quarter. Following up on Kyle's question earlier, CAD was, I think, $43.5 million, and I believe that there was a $5 million benefit from the Velocity cash reversal, say. So "normalized" is more of a kind of $38.5 million CAD run rate. That being said, were there any other kind of onetime items or other noise to consider as we look at third quarter CAD, just given I think, even $38.5 million is a record number kind of despite the challenging backdrop?

Ryan J. Faulkingham
Executive Vice President, Chief Financial Officer & Co-Compliance Officer, Compass Diversified Holdings, Inc.

A

Nothing else meaningful. Derek, this is Ryan. It's really driven primarily by just really strong EBITDA performance.

Derek Hewett
Analyst, BofA Securities, Inc.

Q

Okay. All right. Thank you very much.

Elias J. Sabo
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.

A

Thank you, Derek.

Operator: I would now like to turn the call over to Elias Sabo for any closing remarks.

Elias J. Sabo
Partner, Chief Executive Officer & Director, Compass Diversified Holdings, Inc.

Thank you, operator. I'd like to take a moment to inform our shareholders, analysts, and capital providers that our Investor Day will be held virtually on December 10. We will be highlighting our most recent acquisition, BOA, and we'll have remarks from its CEO, Shawn Neville. We will have a public announcement shortly, but wanted everyone to mark their calendars. In the meantime, we hope everyone heads out and picks up a pair of shoes with the BOA Fit System and experiences firsthand its performance-enhancing technology.

As always, I'd like to thank everyone again for joining us on today's call and for your continued interest in CODI. We look forward to sharing our progress with you in the future.

And with that, the call is over. Thank you, operator.

Operator: Thank you. That does conclude today's conference. Thank you for participating. You may now disconnect.