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Market Intelligence

# Compass Diversified NYSE:CODI

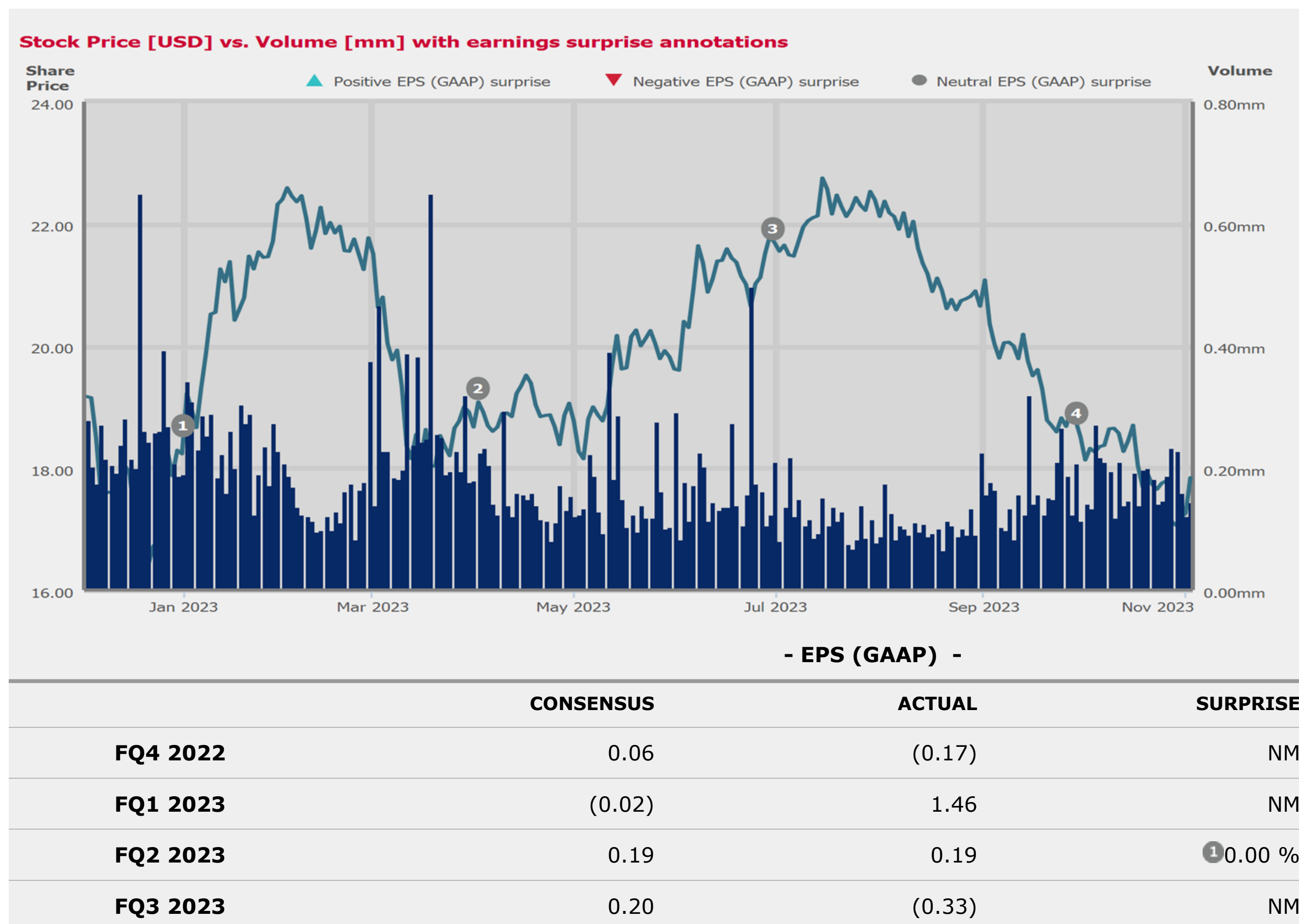
# FQ3 2023 Earnings Call Transcripts

## Thursday, November 02, 2023 9:00 PM GMT

## S&P Global Market Intelligence Estimates

| | -FQ3 2023- | | | -FQ4 2023- | -FY 2023- | -FY 2024- |
|---|---|---|---|---|---|---|
| | CONSENSUS | ACTUAL | SURPRISE | CONSENSUS | CONSENSUS | CONSENSUS |
| **EPS (GAAP)** | 0.20 | (0.33) | NM | 0.15 | 1.76 | 1.42 |
| **Revenue (mm)** | 574.80 | 569.56 | (0.91 %) | 594.89 | 2236.06 | 2418.65 |

Currency: USD
Consensus as of Oct-04-2023 10:05 PM GMT




**- EPS (GAAP) -**

| | CONSENSUS | ACTUAL | SURPRISE |
|---|---|---|---|
| **FQ4 2022** | 0.06 | (0.17) | NM |
| **FQ1 2023** | (0.02) | 1.46 | NM |
| **FQ2 2023** | 0.19 | 0.19 | 0.00 % |
| **FQ3 2023** | 0.20 | (0.33) | NM |

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# Presentation

**Operator**

Good afternoon, and welcome to Compass Diversified Third Quarter 2023 Conference Call. Today's call is being recorded. [Operator Instructions]

At this time, I would like to turn the conference over to Cody Slach of Gateway Group for introductions and the reading of the safe harbor statement. Please go ahead, sir.

**Cody Slach**
*Senior MD & Director of Investor Relation*

Thank you, and welcome to Compass Diversified's third quarter 2023 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 2023 press release, including the financial tables and non-GAAP financial measure reconciliations for adjusted EBITDA, adjusted earnings and pro forma net sales are available at the Investor Relations section on the company's website at compassdiversified.com.

The company also filed its Form 10-Q with the SEC today after the market close, which includes reconciliations of certain non-GAAP financial measures discussed on this call and also -- is also available at the Investor Relations section of the company's website. Please note that references to EBITDA in the following discussions refer to adjusted EBITDA as reconciled to net income or loss from continuing operations in the company's financial filings. The company does not provide a reconciliation of its full year expected 2023 adjusted earnings or adjusted EBITDA because certain significant reconciling information is not available without unreasonable efforts. Throughout this call, we will refer to Compass Diversified as CODI or the 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 expectations related to the sale of Marucci and the future performance of CODI and its subsidiaries, the impact and expected timing of acquisitions and divestitures, including the divestiture of Marucci and future operational plans such as ESG initiatives. Words such as believes, expects, anticipates, plans, projects, should, 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 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, 2022, as well as in other SEC filings.

In particular, the domestic and global economic environment, supply chain, labor disruptions, inflation and rising interest rates, all may have a significant impact on CODI and 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 Joseph Sabo**
*Partner & CEO*

Good afternoon, everyone, and thanks for joining us today. Before I discuss our third quarter results, I would like to cover the press release we issued this afternoon, announcing the agreement to divest Marucci Sports to Fox Factory Holding Company at an enterprise value of $572 million. CODI expects to realize a pretax gain on the sale of between $225 million to $245 million, and we expect the net proceeds will be used to pay down outstanding debt and for general corporate purposes. We are extremely proud of the growth Marucci has experienced under our ownership, and we feel fortunate to have been able to

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partner with their outstanding team. We acquired the business in April 2020 based on our confidence in both Marucci's brand and management.

Keep in mind, this was at a time when few transactions were being completed due to the pandemic, but our flexible capital structure and our commitment to seizing strong opportunities, even in times of economic uncertainty allowed us to execute at a time when others weren't. Since then, the Marucci team has acted decisively, strengthening their brand and growing their core business. They have gained share in new markets like fielding gloves and softball. We have also expanded the Marucci product portfolio by acquiring Lizard Skins and Baum Bat. We are honored to have partnered in this success. Thank you to Kurt and the entire Marucci team for their contributions over the last several years. We wish them nothing but continued success.

Now on to our third quarter. We are pleased to report remarkably strong third quarter results, which once again exceeded our expectations and have us raising our full year outlook. Our consistently strong results reflect not only the diversification of our subsidiaries, but our ability to find excellent businesses that produce category-leading growth. To underscore this point, since 2019, we have grown consolidated subsidiary adjusted EBITDA for 4 straight years despite volatile economic cycles and a once-in-a-generation pandemic. I am pleased to tell you, given our increased subsidiary adjusted EBITDA guidance that Ryan will highlight shortly, we fully expect 2023 to be a fifth straight year of growth. During the third quarter, pro forma consolidated revenue declined by 1%, while pro forma adjusted EBITDA grew 11%.

EBITDA margins expanded by approximately 250 basis points to a record 21.9% in the quarter. The decline in revenue was due to our industrial businesses. While they benefited from lower commodity input costs driving the 19% EBITDA growth, we passed some of those lower input costs on to our customers and experienced a mix shift to higher margin categories, resulting in an 8% decline in revenues. When you look at year-to-date EBITDA performance, our industrial businesses have performed exceptionally well, posting 14% growth. We expect this segment to produce strong growth in the fourth quarter and into 2024. Our branded consumer businesses exceeded our expectations by growing in the third quarter.

Pro forma revenues increased by 2% and EBITDA increased by almost 9%. This represents the first quarter of positive EBITDA growth this year. As we have stated many times before, inventory-related destocking headwinds have significantly lowered our consumer growth rate in 2023. Even though these headwinds still existed in the third quarter, we were able to produce solid growth. While we expect inventory destocking to continue in the fourth quarter, comparisons to prior year are expected to ease and we expect growth rates will further accelerate. Given the broader difficult macroeconomic backdrop, we are certainly pleased with our subsidiaries' resilience and performance to date, and we remain confident in an even stronger 2024.

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

**Patrick A. Maciariello**
*Partner & COO*

Thanks, Elias. Throughout this presentation, when we discuss pro forma results, it will be as if we owned PrimaLoft from January 1, 2022. As Elias mentioned, performance in Q3 materially exceeded our expectations, and we experienced significant growth in both our consumer and niche industrial segments. Lugano continue to perform extremely well, driven by new salon openings, a strong management team and a disruptive business model. Last quarter, we mentioned that we faced headwinds in several segments due to correcting inventory levels in the supply chain. These headwinds have eased in certain areas but remain in others.

Specifically, in Q3, though financial performance was muted at BOA, bookings turned positive. PrimaLoft, on the other hand, continue to see reduced demand as apparel makers remain cautious about consumer demand in 2024. Though a significant headwind to CODI's performance in 2023, we continue to expect these businesses to become a tailwind as the rate of inventory destocking continues to decrease. Though it may not happen at the same time for PrimaLoft and BOA due to different industry dynamics, we are confident it will happen for both.

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Now on to our subsidiary results. I'll begin with our niche industrial businesses. For the year-to-date period ending September 2023, revenues declined by 5.7%. However, adjusted EBITDA increased by 14.5% versus the same period last year. For the third quarter, adjusted EBITDA increased by 19%. On a combined basis, our industrial businesses expanded margins in the quarter significantly, and consolidated adjusted EBITDA margins grew by over 400 basis points versus the prior year's quarter. Though adjusted EBITDA declined slightly for Arnold in the third quarter, for the year-to-date period, the company continued to show solid growth in revenue and adjusted EBITDA as they gain traction securing new projects across markets.

Demand levels in the aerospace and defense markets remain elevated, driven by the commercial aerospace sector. And for the year-to-date period, the company's book-to-bill ratio remains above 1. Altor continued to show profit growth in the quarter as adjusted EBITDA increased by almost 21% in the year-to-date September period. Though revenue continues to be pressured as lower margin, more cyclical end market space headwinds and the company passed on contractual raw material savings, the efficiency gains made by the management team at Altor significantly more than offset these revenue headwinds. At Sterno, revenue declined by approximately 8% in the year-to-date September period compared to a year ago, again, driven by lumpiness in the company's scented wax business. Despite this decline, the company continued to operate efficiently and benefit from reduced input and shipping costs, leading to growth in EBITDA of over [ 40% ] in the quarter and 12.5% on a year-to-date basis.

Turning to our consumer businesses. For the year-to-date September 2023 period, revenues increased marginally and adjusted EBITDA declined by 2.2% as compared to the prior year. As a group, these businesses showed significant improvement in the third quarter, however, as revenue and adjusted EBITDA increased by 2.1% and 8.6%, respectively, versus Q3 '22. We are hopeful that Q3 represented a turning point for BOA, while the company continued to show decline in adjusted EBITDA through the year-to-date period, bookings were positive in Q3 versus prior year, and our belief is that the worst of the inventory destocking headwinds are behind us for this business. As we approach ski season, the buzz surrounding the launch of Alpine boots incorporating our technology continues to gain momentum and we anticipate a strong launch.

Lugano's growth accelerated further in the third quarter. And for the year-to-date period, revenues and adjusted EBITDA grew by 48% and over 56%, respectively, compared to prior year. The company benefited from a solid increase in average transaction size in the quarter and saw strong growth in many of its salons, including Washington, D.C. and its new Greenwich, Connecticut salon. Progress continues to be made on our second flagship salon in Palm Beach, and we anticipated opening in the fourth quarter. Similarly, construction of the company's London salon is scheduled to begin prior to year-end, and we anticipate opening in the first half of 2024. The management team at Lugano continues to execute at an incredibly high level, and we look forward to 2024.

Marucci once again had an exceptional quarter. And for the year-to-date period, revenue and adjusted EBITDA grew by over 17% and over 50%, respectively, compared to the year ago period. PrimaLoft continued to show modest declines in both revenue and adjusted EBITDA in the September year-to-date period as compared to the prior year. As we enter booking season for fall/winter of 2024, brands remain cautious. Though the company is adding new programs and customers, and we have experienced very little customer attrition, we anticipate a muted Q4, but remain optimistic about the company's prospects in 2024 and beyond. Under CODI ownership, PrimaLoft remains well positioned, and we believe it will prosper following industry-wide inventory destocking trends in the apparel business.

5.11 had another solid third quarter, and for the year-to-date September 2023 period, revenue and adjusted EBITDA grew by 10% and 8.6%, respectively. Though the company is not immune to the headwinds facing consumers today, 5.11 once again benefited from its diverse channel mix as its professional sales increased both domestically and internationally during the quarter. We continue to see this momentum in the fourth quarter. Velocity continued to struggle in the third quarter, though performance did improve significantly on a sequential basis.

We continue to focus both on cost controls and demand stimulation and believe performance will improve in 2024. Before turning the call over to Ryan, I wanted to discuss a regulatory change coming in the near

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future impacting our business. As has been broadly covered, California and several other states have enacted laws, banning the sale and distribution of textiles containing PFAS chemicals effective January 1, 2025. These chemicals are used broadly to impart water resistance and oil repellency and prevent staining. Amongst our subsidiaries, this regulatory change will have the most impact on 5.11. However, they have been proactive in sourcing non-PFAS versions of impacted products and will be transitioning in 2024. As a whole, we are pleased with our performance in the third quarter as it came in significantly above our expectations. While inevitably, there will always be challenges in a broad group of diversified businesses, the quarter's performance once again demonstrated the strength of our model, and we look forward to growth in the fourth quarter and in 2024.

I will now turn the call over to Ryan for his comments on our consolidated financial results.

**Ryan J. Faulkingham**
*Executive VP, CFO & Co-Compliance Officer*

Thank you, Pat. Moving to our consolidated financial results for the quarter ended September 30, 2023. I will limit my comments largely to the overall results for CODI 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, 2023, was $569.6 million, down 1% compared to $575.8 million for the prior year period. This slight year-over-year decrease primarily reflects declines at Velocity and at BOA as a result of inventory destocking headwinds, partially offset by strong revenue growth at Lugano and Marucci. Consolidated net loss for the third quarter was $3.8 million compared to net income of $2.6 million in the prior year. The decrease was primarily due to impairment expense recorded at Velocity Outdoor of $32.6 million, partially offset by strong consolidated gross margin performance.

Adjusted EBITDA in the third quarter was $103.9 million, up 13% compared to $91.9 million in the third quarter of '22. The increase was due to an expansion in EBITDA margin at a consolidated level as our industrial companies expanded margins significantly, as Pat highlighted earlier. EBITDA margin expansion at our consumer businesses were primarily due to Lugano and Marucci. Adjusted earnings for the third quarter was significantly above our expectations at $41 million. This was down from $41.6 million in the prior year quarter, primarily due to increased interest expense, but up sequentially by over 15%. Adjusted earnings were above our expectations, also due to the strong performance at Lugano and Marucci.

Now on to our financial outlook. We are pleased to announce that we are raising our full year adjusted EBITDA and adjusted earnings guidance as a result of the strong performance in the third quarter. We are continuing to include Marucci in our guidance ranges as we are not certain, the timing of the close of that sale process. For the full year 2023, we now expect consolidated subsidiary adjusted EBITDA to range between $450 million and $465 million, an increase of $12.5 million at the midpoint. This implies 4% growth over the prior full year adjusted EBITDA, pro forma for the acquisition of PrimaLoft and implies our fourth quarter 2023 consolidated subsidiary adjusted EBITDA will be up over 10% from the prior year comparable period. For the full year 2023, we expect adjusted earnings to range between $130 million and $140 million, an increase of over $13 million at the midpoint.

Turning to our balance sheet. As of September 30, 2023, we had approximately $64.7 million in cash, approximately $486 million available on our revolver and our leverage was 4.03x. Our leverage decreased sequentially, and we expect it to decline in the fourth quarter. We have substantial liquidity. And as previously communicated, we have the ability to upsize our revolver capacity by an additional $250 million. Upon the close of the Marucci sale process, which we expect in the fourth quarter, we anticipate using the proceeds to pay down existing debt and for general corporate purposes. With our liquidity and capital, we stand ready and able to provide our subsidiaries with the financial support they need, invest in subsidiary growth opportunities and act on compelling acquisition opportunities as they present themselves.

Turning now to cash flow provided by operations. During the third quarter of 2023, we received $19.7 million of cash flow from operations, primarily a result of strong operating performance. This is up $24.3 million from the prior year's comparable period. During the third quarter, we used $48.7 million in working

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capital, a substantial decrease from $62.8 million in the prior year when we needed to support many of our business's inventory levels as a result of supply chain disruptions. For the year-to-date period, cash flow provided by operations has increased almost $100 million as compared to the prior year.

Year-to-date, Lugano has consumed $139 million in working capital to fund its inventory growth, which has generated exceptional return on invested capital and enabled the strong year-to-date growth rate we have experienced. We expect to continue to monetize working capital across the business in Q4 with the exception of Lugano as we continue to fund its growth objectives. And finally, turning to capital expenditures. During the third quarter of 2023, we incurred $12.1 million of capital expenditures at our existing subsidiaries compared to $15 million in the prior year period. The decrease was primarily a result of the timing of retail build-outs at Lugano and 5.11 to support their continued growth. For the full year of 2023, we anticipate total capital expenditures of between $60 million and $70 million. We continue to see strong returns on invested capital at several of our growth subsidiaries and believe they will have short payback periods. Capital expenditures in the fourth quarter will primarily be at Lugano for new retail salons.

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

**Elias Joseph Sabo**
*Partner & CEO*

Thank you, Ryan. I would like to close by briefly providing an update on the M&A market and our strategic initiatives. In terms of M&A, we have seen some green shoots emerge with a few higher quality deals being reviewed. But overall, markets are weak. Of course, the current economic backdrop suppresses M&A activity with rising borrowing costs and treasury yields hitting 20-year highs. The lack of visibility continues and as we remain on the sidelines, we continue to strengthen our pipeline of targets for each of our verticals, including health care and fully expect to capitalize once the broader market headwinds ease.

In the realm of ESG, our steadfast objective has always been to create tangible social and environmental benefits that resonate with our core values while delivering robust financial returns for our stakeholders. Transparency and accountability have remained the cornerstones of our business ethos, driving us to invest in people, refine processes and explore growth avenues that pave the way for transformative long-term changes within our companies. Throughout 2023, we have developed a systemic approach to ESG initiatives. We focused on climate action with a number of new programs aimed at waste reduction and emissions, both Scopes 1 and 2. We have made progress on social responsibility with diverse new hires, new programs designed to improve the well-being of our employees and by strengthening partnerships with community organizations.

We've recently developed our human rights and labor policy and through sound corporate governance, we continue to uphold the highest standards of ethics, transparency and accountability in order to safeguard our shareholders' interest. We are also collaborating with each of our subsidiaries so that they too can create their own ESG strategies that align with our vision. I extend my gratitude to our dedicated employees, shareholders and all stakeholders who have partnered with us in our journey towards positive change and sustainable value creation. Moving forward, Compass remains committed to driving positive change and leading the industry to become the model of choice through our unwavering commitment to ESG principles. We will continue to innovate, collaborate and set an example for others, ensuring our business practices not only meet the demands of the present, but also enhance the future.

In conclusion, we're proud of our third quarter results. They continue to highlight the benefits of our strategy. Owning a diversified group of strong, disruptive and industry-leading businesses is how we were able to produce the robust double-digit adjusted EBITDA growth we saw this quarter. As we continue to work through this period of uncertainty, we are entering the end of the year from a position of strength. The strategic decision to divest Marucci will allow us to deleverage our balance sheet and provide ourselves with strong liquidity to act when we feel is appropriate. I'd like to extend my thanks to the entire CODI family for their strong execution during the quarter amidst the persistent challenging environment.

Before turning over to Q&A, I'd like to mention that we will be hosting our Investor and Analyst Day in Newport Beach, California on January 17, 2023. We will be showcasing our Lugano Diamonds subsidiary

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with presentations from Lugano and CODI management, and we will hold the event at their newest membership club, Prive. Expect more details in the coming weeks, but we hope to see you all there. With that, operator, please open the lines for Q&A.

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# Question and Answer

**Operator**

[Operator Instructions] Your first question comes from the line of Larry Solow from CJS Securities.

**Lawrence Scott Solow**
*CJS Securities, Inc.*

Great. Congrats on the announced sale. It looks like 11.5x trailing EBITDA, I don't remember [ if it was correct that is ] what you have paid for it, but, of course, you've grown the business quite sound since. So I guess first question related to that is in terms of reducing the debt, are there any restrictions or you'll be able to reduce sort of the, I guess, the variable piece first, right...

**Ryan J. Faulkingham**
*Executive VP, CFO & Co-Compliance Officer*

Yes, Larry, this is Ryan.

**Lawrence Scott Solow**
*CJS Securities, Inc.*

Yes.

**Ryan J. Faulkingham**
*Executive VP, CFO & Co-Compliance Officer*

Yes. So sorry, there's -- yes, there's no inability of us. We could pay our revolver back and our Term Loan A, both are prepayable.

**Lawrence Scott Solow**
*CJS Securities, Inc.*

Got it. Okay. Great. And then just switching gears, Elias, you gave us a good kind of state of the union on the M&A environment. How about just in terms of -- obviously, it feels like the consumer has certainly gotten a little bit better through the year and certainly -- or not as worse as we thought it was going to be in the beginning of the year. And it looks like finally, inventory destocking might be starting to wane. But just kind of what's your assessment on where you stand today from where we were at the beginning of the year in terms of your average consumer? I know you had kind of gotten a little bit more optimistic that a lot of your businesses, your consumers weren't being impacted by the slowdown in the economy. But any kind of update on that, those thoughts would be great?

**Elias Joseph Sabo**
*Partner & CEO*

Sure, Larry. I would say if you went back to a year from today or at the beginning of the year, we are much more constructive and positive really across the board. Obviously, our industrial businesses have had a great year, a lot of that. And I know there is some revenue headwind, but a big chunk of that is due to the declines in commodity costs and us sharing those with our customers. So I think you need to look through that because unit growth is still present and the companies are performing exceptionally well on a kind of earnings generation standpoint. We would expect that to continue.

The big change from a year ago and from the beginning of the year is how we look at kind of our consumer businesses. And so when you think about end consumer demand, it's held up better than I think anybody has anticipated over the course of the year. That's not just for us, that's just consumption broadly. And we see strong wage growth that's still out there and employment growth. And I think that's a great underpinning. Clearly, it's kind of counterbalancing some of the increased kind of interest cost and monetary headwinds that we're all suffering from.

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But the consumer has broadly held up. For us, the big issue because a lot of our earnings are generated at the wholesale level, where we're selling into a retailer or even farther down in the case of a PrimaLoft or a BOA. We -- the whole year been sounding the alarm bells that this inventory destocking is a headwind that, frankly, 1.5 years ago, we didn't anticipate. I don't think anybody really did. And it's sort of a generational type of thing. I mean this is all the result of distortions that came out of the pandemic supply chain issues requiring us to over-order kind of across the board and then dealing with all that excess inventory.

So we were very cautious that, that was going to create depression to -- or depress our earnings on our consumer side. And it, in fact, did. Where we stand today isn't to say that those headwinds are gone completely, but the comparisons have become so easy now as we come into the fourth quarter, we feel it's very easy to lap those with companies like BOA, PrimaLoft, Velocity, 5.11, everybody who's through the consumer wholesale market. And as we come into 2024, eventually sell-through will match sell-in.

And when that happens, we expect a real strong snapback in kind of earnings from BOA, PrimaLoft, all the companies that have that wholesale exposure or either or even farther down. I will say for now, we're seeing some sequential improvement in terms of order patterns out of those companies, but it isn't back to where it was 1.5 years ago, but the comparisons have become so easy, they're no longer a headwind. So we are very bullish. We feel Q4 and what we've seen so far in October lead us to believe we're going to have another great quarter. And as we come into '24, we're preparing for what we think is going to be a really strong year.

**Lawrence Scott Solow**
*CJS Securities, Inc.*

Awesome. And could -- you gave a lot of detail, Lugano, obviously, really knocking the cover off the ball. Just on BOA, which obviously, one of your larger consumer brands and probably been taking the brunt, a big impact from the destocking. Can you just speak to some of sort of the operating trends outside of that destocking? I know you had, I think in the beginning of the year kind of projected or called out that you thought SKUs would be up over 10% by this fall compared to last fall. And for what it's worth, I have seen a lot more BOA and [ REI ] circulars and whatnot. So it does seem to be at least anecdotally getting more into the U.S., but just any color on trends that we might actually be seeing in the reported numbers would be great?

**Patrick A. Maciariello**
*Partner & COO*

Sure. I would just -- this is Pat, Larry. I would just say we touched on it that the headwinds in bookings are starting to not be as much headwinds anymore, and I touched on that specifically. We are continuing to grow SKUs. And at every quarterly board meeting, I see solid growth in our SKUs. I don't have the exact numbers in front of me, but it's in that same realm and as you look out to '25 kind of project -- beyond '24, projected SKUs are strong, too. We mentioned Alpine. It's getting a really strong start. If you go in the -- any of the ski outfitters and ski stores, I think they'll tell you the same thing.

It's taking a significant chunk of demand there. And then there's other pockets. I mean, we have some strong momentum in some of our Asian businesses. And you've probably seen the Under Armour SlipSpeed, which is being pushed very well and is a really amazing shoe, I'm wearing them right now. So there's a lot of other pockets of sort of success in growth there.

**Operator**

Your next question comes from the line of Matt Koranda from ROTH Capital. Your next question...

**Elias Joseph Sabo**
*Partner & CEO*

Matt, you are on mute.

**Operator**

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Yes. Your next question comes from Robert Dodd from Raymond James.

**Robert James Dodd**
*Raymond James & Associates, Inc., Research Division*

Congrats on the quarter. On the leverage, I mean, to your point, you have [ $403 million ] after Marucci, the Marucci sale, whatever exactly that is, you're likely -- at least down to the bottom end of your target range of 3x, I think, maybe even slightly below that. Does that increase the likelihood of expanding more vigorously into the health care vertical in 2024, given you will have quite a lot of available capital at that stage by the standards of where you normally make large acquisitions, if that makes sense?

**Elias Joseph Sabo**
*Partner & CEO*

Robert, this is Elias, and thank you for the question. The answer is yes, if I want to be very specific. Clearly, we were being cautious as our leverage had been outside of the stated leverage range that we wanted to be in. And it just so happened to be at a time when M&A activity is at basically 20-year lows. So it wasn't that hard to be patient and disciplined during this time. Having capital available right now, and as you mentioned, being now well within our leverage targets is a really good opportunistic spot for us. And generally, in conditions where it's murkiest, the outlook and kind of -- you can't turn on CNBC or Bloomberg or any of the other financial outlets without hearing kind of what is going to be the economic outcome from all of this monetary tightening and how are consumers going to hold up. And you can name the whole myriad of kind of issues and problems that everybody is looking at right now and how that's going to impact kind of the economy.

And generally, that causes buyers to really tense up. We found historically, when we can be active in markets because we have permanent capital, our capital is committed from our banks, as you know, and we have very -- a lot of flexibility. We found that these are the most ideal times to be an aggressive acquirer. And so it really works out quite well that we're opening up all this balance sheet capacity at a time when economic kind of murkiness is probably reaching its peak. And generally, that creates really good opportunities. To the extent we could deploy and acquire a health care company or 2, that would be outstanding.

And Kurt Roth, who runs our group is sitting next to me right now on this call, and he is pursuing a number of different opportunities that are out there. We have a very robust pipeline. But it takes 2 to tango, as you know. And we need the kind of sellers to be out there, but we have a list of companies that we're following that we think would be great targets within that space. And to the extent they come to market, which we're hearing is going to happen in '24. I think we would love to be able now to more aggressively move into health care and start to get the benefits of a broader diversification strategy that we outlined to you guys 1.5 years ago when we initiated this vertical.

**Robert James Dodd**
*Raymond James & Associates, Inc., Research Division*

Got it. I appreciate that. Yes. And to your point, I mean the timing of the acquisition of Marucci kind of is to exactly that point as well. On Lugano, it's -- it's been very successful. On the working capital question though, look, the ROI has been very strong on the working capital investments as well. But is there a point at which the amount of work, the amount of working capital you've got allocated to Lugano and just the level of compensation there begins to be a concern? And is there a point in which you have to look at alternative -- the only finance of your business is off your own balance sheet. But is there a point at which that doesn't become ideal, given how much working capital that business can consume and utilize?

**Elias Joseph Sabo**
*Partner & CEO*

Yes. I mean, Robert, I think that's a great question and one that we think about all the time. It's not a '24 or '25 issue as we look out. But if this company continues with growth rates, which frankly are just torrid at this point, look, it could get to the point where its sheer size starts to kind of exceed what our diversification sort of efforts would look like. The company is going to continue at these growth rates.

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Clearly, we would be all ecstatic if it can continue at these growth rates. And given the return on invested capital, we're enjoying, we would love to fund that. But your point is very well taken. And what we don't want to do is essentially be a proxy for any one company. And so to the extent that its growth was starting to overwhelm us, that potential opportunity to kind of seek alternative financing and outside financing while still being part of the CODI portfolio clearly exists for us.

I think in the near term, and I'm going to say in the near term over the next couple of years, even on some of the more bullish assumptions that we could make, we don't believe that we would kind of reach that point. But to the extent, it was starting to get there, we would have and do have available to us kind of outside off of our balance sheet financing opportunities that we could pursue. But I do want to point that's a couple of years away. And as if the company was continuing to grow at this level, which is a really high bar that you would -- we would be asking.

**Robert James Dodd**
*Raymond James & Associates, Inc., Research Division*

Yes, yes, yes. Understood. One last one, if I can fill in here. With the California, with the PFAS fabrics, have you done any testing with customers? Do customers notice any performance difference on the alternative fabrics versus the old ones? And frankly, if -- did they care or is it do you think just not going to be an issue because anybody else selling legitimately into California is going to face the same issue?

**Patrick A. Maciariello**
*Partner & COO*

Robert, this is Pat. Let me say it this way. We believe there's a case that certain customers will still want PFAS products, right? And so that creates demand but also complexity. It's a good product. There's also a lot of uncertainty in the enforcement of this regulation. The enforcement agency, I don't believe has been named yet. So there's uncertainty out there as to what's going to happen on 1/1/25. So I can't answer it broadly other than to say it's 7 states. So by definition, 43 other states, at least for now, will still allow PFAS, and that would assume some customers either on the consumer or law enforcement side in those states and internationally would want PFAS product.

**Operator**

Your next question comes from the line of Matt Koranda from ROTH Capital.

**Michael David Zabran**
*ROTH MKM Partners, LLC, Research Division*

It's Mike Zabran on for Matt. Can you hear me all right?

**Elias Joseph Sabo**
*Partner & CEO*

Absolutely.

**Michael David Zabran**
*ROTH MKM Partners, LLC, Research Division*

Okay. Great. Maybe just on the Marucci sale, can you just help us better understand what net proceeds from the transaction after taxes, after fees and after the CGM incentive payment will look like? And what will this do to pro forma net leverage?

**Ryan J. Faulkingham**
*Executive VP, CFO & Co-Compliance Officer*

Yes, sure. This is Ryan. So I think the best way to think about it is $572 million of gross proceeds. And then you could take the diluted ownership percentage and the minority shareholders would share in that. So post minority shareholders, it's about $500 million. From there, we would have -- and these numbers still -- would still need to be calculated. We would have our allocation interest payment as well as tax

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payment given our reclassification to a C-Corp. And that nets all down, again, those numbers aren't finalized, but around $400 million of net proceeds, which we could use to pay off our debt. Is that helpful?

**Michael David Zabran**
*ROTH MKM Partners, LLC, Research Division*

Absolutely.

**Ryan J. Faulkingham**
*Executive VP, CFO & Co-Compliance Officer*

And I think you might have heard earlier about leverage levels will be within our financial policy of 3x to 3.5x.

**Michael David Zabran**
*ROTH MKM Partners, LLC, Research Division*

Got it. That's helpful. Moving to 5.11, maybe just speak to the progress and the status of the retail build-out strategy. I know we're still spending CapEx there. And then where do we stand cleaning up the inventory? It's been a drag on margins in the prior quarters. And lastly, just any call-outs on the mix or purchasing behavior of prosumers versus everyday consumers?

**Patrick A. Maciariello**
*Partner & COO*

Yes, sure. Let's see. On retail, we are -- I'd say we're -- given the current retail environment, we're slowing our store rollout, and we're going to come up with a plan -- a more limited plan for 2024. I would say though that our e-com continues to be a growth, continues to grow. And so let's not say in retail continues to grow. So it's not to say that DTC is not going to be a driver of growth. It just may be a little bit less investment in 2024, and you'll see that in our CapEx numbers holistically when we provide those for 2024.

On inventory, we think we're managing it well. I will -- I've learned long ago never to say never as far as inventory goes, and if you need to take further actions, but we believe we're managing it well. I would -- in a lot of cases, we can sell slow-moving inventory through our DTC channel, which obviously has higher margins, obviously maximizes the chance that you don't have to take any markdown. So never say never, and there's a lot of stuff out like PFAS that we just talked about, but we're going to try hard to manage inventory appropriately. And then the last question is on the prosumer.

Anecdotally, I have heard of the conflict in the Middle East driving pockets of orders here or orders there. I haven't broken that out and I haven't seen that broken out in the professional business specifically. But I would say our professional business has been a driver of growth, was a driver of growth in Q3, and we believe will continue to be a driver of growth in Q4 and really speaks to our diversified model and the strength of that within 5.11 specifically.

**Michael David Zabran**
*ROTH MKM Partners, LLC, Research Division*

Got it. That makes a lot of sense. Last one for me. I guess just preliminarily, how are we thinking about top line growth in 2024? Maybe just speak to which brands might be leading the way and why and then which brands like a couple of group of brands could be potentially more constrained based on today's environment?

**Elias Joseph Sabo**
*Partner & CEO*

Yes. So Mike, we don't give sort of top line growth targets. We typically give EBITDA growth. And as you know, with 10, I guess, now going down to 9 subsidiaries, that can vary and margins are a lot different. And so we focus a little bit less on top line, and we've always focused on kind of EBITDA and adjusted earnings as the right metrics. As I said earlier, and to start the call, holistically, we feel that Q3 was a

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turning point for us, and that there's accelerating results in Q4 and 2024 should be a really good year for us. And I would say if you think about what we've said historically, our core growth, we expect to be high single-digit, possibly low double-digit. We're going to be, call it, half of that this year.

Is it possible next year? We have enough growth to make up for kind of coming in underneath it. So that over the 2-year period together, we get back to our core growth. It's absolutely possible. Now I'm going to ask everyone not to take that as a kind of early guidance, but I'm saying that is a possibility given what we're seeing right now and trending. If you want to get a little bit more granular, I would say we look at our industrial vertical, which has had a phenomenal year in 2023, it's likely slowing the pace of growth in '24, but still having good growth. That's not a double-digit growth kind of vertical. We've never thought of it as that. So I think that probably reverts back to something that is more normalized, which is kind of a mid-single-digit growth.

And then within the consumer business, I think as you look across it, clearly, we have big expectations for Lugano. We expect to continue to have large funding needs that will go into that. One of the things with Lugano is it's not an up-leveraging. When we fund additional working capital, the way that translates into EBITDA growth doesn't add leverage. It's not a huge deleverager but it isn't an up-leverager as well. And so Lugano, we continue to remain with very high expectations. I think you're going to see BOA come back with some pretty good growth probably as the year develops and inventories start to -- sell-in starts to match sell-through.

My sense is you're going to see that accelerating pretty strong, but we have pretty good expectations on that. And I think in general, we would see our consumer businesses getting back holistically to be kind of that double-digit type growth business that it's been historically and that we would expect going forward, which drives sort of the consolidated growth rate in that high single-digit, low double-digit range. So it's a little early for us to give too much more granularity than that, but I would say it feels like there's some tailwinds coming. In terms of are there any problem areas that we look at coming into 2024, the answer is no. Right now, we suffered through a really difficult year with consumer wholesale, and that negatively impacted 5.11 and negatively impacted ERGObaby, it negatively impacted at a big time level, Velocity, PrimaLoft and BOA.

And so we look at that and say if those -- if that huge negative is starting to subside, it is eventually going to actually turn into a positive, I think that really bodes well for our business. And that's kind of a idiosyncratic microeconomic issue that's benefiting us. I don't really know the macro and how '24 is going to shape up. It could be a soft landing, it could be a shallow recession, could be continued growth. I think none of us really know, that's creating the murkiness. But regardless of that, I think the micro kind of economic outlook that each of our companies are suffering from or benefiting from going forward give us great optimism that there really aren't right now anticipated problem areas coming in the portfolio in 2024.

**Operator**

Your next question comes from the line of Cris Kennedy from William Blair.

**Cristopher David Kennedy**
*William Blair & Company L.L.C., Research Division*

Can you talk about the wide range of guidance for the fourth quarter? What brings you to the upper end of the range and what brings you to the lower end some of the puts and takes?

**Ryan J. Faulkingham**
*Executive VP, CFO & Co-Compliance Officer*

Yes, sure. Cris, I'll take that, and Elias, you can add some color. Certainly, we've highlighted as part of our script, the expectations for adjusted EBITDA, we think it will be -- midpoint of that guidance implies greater than 10% growth. So that's obviously very positive. We feel certainly good about that. Adjusted earnings is -- can be interesting as you get into the fourth quarter, specifically around taxes, which is probably a broken record on behalf of Compass, but taxes can be challenging for 10 different subsidiaries, having different tax situations that can impact fourth quarter specifically. So just maintaining a little bit

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of conservatism there. If you run those numbers, the midpoint of adjusted earnings implies some growth over last year, but not as much as adjusted EBITDA. And we certainly could get there if taxes turn out to be less than we anticipated.

**Elias Joseph Sabo**
*Partner & CEO*

Yes. And Cris, I'll just follow up to say kind of the range that we give. Obviously, we're 1/3 of the quarter through right now, and we have decent visibility on where revenues came out in October. I think I also mentioned earlier in the call based on what we saw in October, it would lead us to be more bullish, not more pessimistic and probably lead us to be more at the high end of the range, not the low end because it was a very positive October that we saw sort of across the board. But that being said, as you know, there's 2 very important months. And as holiday season approaches, it becomes really meaningful.

The #1 determinant that can swing our earnings within that range is, frankly, how Lugano does. And we know it's a large kind of business within our portfolio. It is also one that doesn't have a backlog and it's benefited by being the end distributor of the product throughout the year and not having inventory destocking headwinds, but it also has the shortest visibility because every day we wake up and we look at what the sales were from the day before to figure out how the company is doing. And so it gives the level of uncertainty, obviously, because we don't have that backlog. Outside of that, I think most of our other businesses either work on backlogs and of some varying length that give us a little bit more confidence, but I think within that range, the high end of the range or exceeding the high end will be predicated on performance at Lugano.

And what we've seen over the last -- over really the course of this year, but even over the last month in October and before that, frankly, gives us a lot of confidence that they're going to perform like they have been throughout the year. And so we feel really good about the guidance range and hopefully being able to do what we've done all year, which is give a guidance range and then come in and be able to exceed it and kind of raise guidance, although since it's the fourth quarter, the last part of that isn't applicable. But I think we want to provide something that we feel very certain about and then hopefully be able to over-deliver on expectations.

**Cristopher David Kennedy**
*William Blair & Company L.L.C., Research Division*

Yes. Very helpful. And then just a follow-up on PrimaLoft, I think you talked about softer demand there. Can you just talk -- give us a reminder on kind of the visibility of that business and when we should start to see bookings improve or whatnot?

**Patrick A. Maciariello**
*Partner & COO*

Yes. So we're starting to book now for fall/winter of 2024 for the most part. And so that's where I was saying that a lot of the brands are cautious. If you read -- I won't name the names, but if you read some of the big brands' discussions, they're cautious about what the first half of 2024 is going to look like, that obviously flows through to how they order, right? And so we're -- our hope is that what we're going to do is see later orders and kind of see that order book build later over time, but we're just not there yet in the fall/winter '24 booking cycle.

**Operator**

[Operator Instructions] Your next question comes from the line of Barry Haimes from Sage Asset Management.

**Barry George Haimes**
*Sage Asset Management, LLC*

Congrats on the quarter. I had 2 questions. One is getting back to the inventory destock primarily in consumer, if next year, you got to a point where sell-in and sell-through matched, what sort of range of incremental revenues would you get next year or said another way, how much were revenues hurt

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this year by the fact that sell-in was less than sell-through? And then my second question is on Lugano, realizing that each location is a little different, could you give us just sort of a rough range to stand up a new location between CapEx and working capital? What kind of range per location we're talking about?

**Elias Joseph Sabo**
*Partner & CEO*

Sure. And thank you for the question. So in terms of kind of inventory destocking, it's impossible to tell because we don't get from our -- from our customers exactly what their sell-through is and what their sell-in is. I can tell you anecdotally for PrimaLoft, for example, one of their customers we talked to -- and as Pat said, we don't name names of customers, but we talked to our -- a person who's handling the general management of that product, and they said, yes, we expect to be up double digits with it, and we talked to the purchasing department and they said, yes, your sales are going to be down 20%, your orders.

So that would kind of correlate to, call it, a 30% plus or minus inventory contraction that is -- or kind of net cost of inventory contraction to our revenues this year. I think broadly, I would say between 20% and 40% seems about right. I gave you one other anecdotal piece of evidence. One of our own companies, which is farther up the supply chain, we asked our CEO, what are our purchase orders right now relative to what they would normally be to the factory and believe it or not, they're down about 50%. And so I think it's going to vary by company and to further the point of how long do you think until we're reverting back to normal orders to our factory and the response was we'll probably be back to open to normal by mid next year.

So that means orders will start getting to those factories 90 days to 120 days in advance. So in this particular company, we're probably looking at year-end when we start to open up orders to a more normalized basis. So I think it's impossible to tell. I would be absolutely stunned if the impact was less than 20%. And I can tell you it's not more than 50%, but I think 20% to maybe 30% is probably if you ask for a gut kind of instinct and a swag feels like the right number. In terms of Lugano, I'll let Pat answer that, and...

**Patrick A. Maciariello**
*Partner & COO*

I mean, there's a broad range based on the store, it can be from $4 million to $10 million or plus of CapEx based on the store and then inventory is at least the high end of that is kind of what we stuck it with and probably a little more.

**Elias Joseph Sabo**
*Partner & CEO*

So I think if you're modeling it, I would say $15 million to $20 million of total investment that goes into the business between CapEx and inventory. And then we stand these things up. And look, we expect to get very high returns on invested capital, 30%, 40% types of return on that.

**Operator**

There are no further questions at this time. I would now like to turn the conference back over to Mr. Elias. Sir?

**Elias Joseph Sabo**
*Partner & CEO*

Thank you, operator. As always, I'd like to thank everyone again for joining us on today's call and for your continued interest in CODI. Thank you for your support.

**Operator**
This concludes Compass Diversified's conference call. Thank you, and have a great day.

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