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Compass Diversified Holdings, Inc. (CODI)

Q4 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon. And welcome to Compass Diversified's Fourth 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 of 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 fourth 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 Q4 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-K 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 to net income in the company's financial filings. The company does not provide a reconciliation of its full-year expected 2021 adjusted EBITDA or 2021 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 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 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 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, 2020, 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 fourth quarter earnings conference call. Before discussing our results, I would like to take a brief moment to acknowledge the extraordinary efforts of our employees as we navigated through the unprecedented challenges of COVID-19. Despite working remotely for most of the past year, our employees executed at an extremely high level and delivered results far in excess of our expectations.

During the year, we successfully completed two transformational acquisitions, raised debt and equity capital at attractive rates to solidify our balance sheet, appointed two CEOs at our subsidiary companies, and produced financial results that not only exceeded our expectations, but also produced organic growth on a pro forma basis over 2019. Most importantly, we were able to achieve these accomplishments without faltering on our unwavering commitment to our team, prioritizing employee health and safety.

Despite the challenges brought on by the pandemic, I'm pleased to report that our fourth quarter results dramatically exceeded our expectations. Including BOA and Marucci, as if we owned them from January 1, 2019, pro forma consolidated revenue grew by 11% and adjusted EBITDA grew by 9% over prior year's quarter. For the full year ended of December 31 2020, pro forma consolidated revenue grew by 2.5% and adjusted EBITDA grew by 2% over 2019. With respect to our previous guidance range of $270 million to $280 million, which at our Investor Day we communicated that we expected to be at the high end of the range, we are pleased to report that we significantly exceeded the high end of the range with consolidated pro forma adjusted subsidiary EBITDA of over $290 million.

These results are a testament to our strategy of acquiring industry-leading niche companies and then actively managing them by working closely and supporting our subsidiary management teams to enhance value for our stakeholders. Our subsidiary management teams moved swiftly upon the onset of COVID-19 creating a safe and healthy workplace for our associates, while taking the necessary action to reduce discretionary cost. As the impact of the pandemic started to become more apparent, our management teams were nimble and reacted quickly to pivot and take advantage of opportunities in their respective markets.

As you know, each CODI subsidiary faced unique challenges with some experiencing large declines in end market demand, while others experienced rapid and anticipated increases. An environment this volatile required skillful navigation by our teams and I am extremely pleased to report that our subsidiary management team and their employees delivered above and beyond. Their tremendous efforts and continued focus during 2020 helped enable us to navigate the pandemic in a position of strength.

Although last year was difficult for everyone to endure, the crisis highlighted the advantages of our permanent capital model as we execute our private equity-like strategy. While most private equity firms were largely sitting on the sidelines with limited access to capital, we enjoyed open access to the capital markets as evidenced by our capital raise in May 2020. With our balance sheet strong, we were able to acquire two world class niche consumer businesses at attractive valuation. Very few others were able to make that same kind of impact.

Our permanent capital business model is fundamentally advantaged against our peer set as we have the freedom to divest opportunistically like we did in 2019 with almost $1 billion in enterprise value in these divestitures and then aggressively deploy in times of market dislocation like we did in 2020, acquiring almost $700 million in new businesses.

As we've mentioned throughout the year, the acquisitions of Marucci and BOA have transformed our portfolio and raised our core growth rate substantially. The performance of these businesses since our acquisition vividly demonstrates this growth leveraging. Marucci, in the six months from July 1, 2020 to December 31, 2020 as compared to the same period last year, has experienced approximately 20% revenue growth and 70% EBITDA growth despite new sports in various levels of restrictions around the country. Similarly, BOA experienced revenue growth of 2.5% and EBITDA growth of 29%, substantially above expectations for the fourth quarter and compared to the same period last year.

These two stellar companies possess all the attributes we look for in branded consumer acquisition candidate, highly aspirational brands, premium product positioning, and proven and extraordinarily talented leadership. As I mentioned, our subsidiary management teams perform to their best this year and CEO, Kurt Ainsworth at Marucci and Shawn Neville at BOA we're no different. We have a strategy that has long proven that companies with characteristics like these will be positioned for accelerated growth for years to come.

We entered 2021 with significant momentum at our back. Our consumer businesses on a pro forma basis grew at a remarkable level of greater than 40% over the back half of 2020 and early in 2021, we continue to see well above trend growth in this segment. While our industrial businesses suffered in 2020 due to reduced end market demand, we believe our growth rate will turn back positive in this segment as soon as the second quarter with comparable quarters becoming much easier. For us to achieve this type of performance in a dislocated market, highlights the substantial benefits of our diversification strategy in lowering our financial volatility. Based on these trends, for 2021, we expect to produce consolidated subsidiary adjusted EBITDA of between $305 million and $325 million, representing growth of 5% to 12% and a payout ratio of between 80% and 70%.

Before turning the call over to Pat to review our subsidiary results, I want to take a minute to discuss our strategy for 2021 and beyond. We believe we have created a fundamentally better way to execute a private equity-like strategy. Core to that is our permanent capital structure, which allows us the freedom to acquire and opportunistically divest businesses without deference to timeline. As management has proven over the past few years, we have the financial flexibility to act based on opportunities that arise relative to current market conditions. And as you know, our management is committed to staying in alignment with our stakeholders at all levels of our organization and its subsidiaries, as evidenced by waiving millions of dollars in management fees over the past few years.

Of the utmost strategic importance is the relentless pursuit of a lower cost of capital. Over the past few years, we have made major strides in reducing our weighted average cost to capital by including preferred equity and unsecured bonds in our capital structure. We believe there are numerous opportunities to continue to lower our cost of capital and further enhance our competitive advantage in the marketplace. As Ryan will mention later in his section, we will continue to evaluate the merits and risks of a potential change in our tax structure from a pass through entity to a C corporation. We are still too early in our evaluation process to provide insight; however, any decision will be predicated on our desire to achieve the lowest cost of capital possible for our shareholders because we believe that is what will deliver the greatest level of long-term shareholder value.

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 on our subsidiary results, I want to touch generally on the year. Over the course of 2020, as well as during the fourth quarter, our branded consumer businesses benefited from increased demand in outdoor categories, and as a result, experienced strong sales and earnings growth. Our niche industrial businesses exceeded our mid-year expectations as a group, both sales and earnings continue to face headwinds predominantly driven by pandemic-related travel slowdowns and uncertainty.

Now, onto our subsidiary results. I'll begin with our niche industrial businesses. For the full year, revenues declined by 5.6% and EBITDA decreased by 18.3% versus 2019. For the fourth quarter of 2020, revenues increased by 4.7% and EBITDA declined by 23.8% versus the comparable period in 2019.

For the year, revenue at Advanced Circuits declined by 3% and EBITDA by 9.1% versus 2019. The fourth quarter was challenging for Advanced Circuits as uncertainty surrounding defense budgets following the results of the presidential election caused a reduction in customer demand for circuit boards used in research and development projects. We have seen these trends stabilized somewhat beginning in the middle of January and the company's bookings have shown considerable improvement in the period since then. We anticipate ACI's results in 2021 will be in line with those in 2020.

Arnold Magnetic EBITDA declined to $9.3 million in 2020 as compared to $15.4 million in 2019. Arnold's performance for the year was impacted partially by reduced activity in the aerospace and oil and gas related segments of the economy, as well as severance and related charges associated with this decreased activity. While revenue for the year declined by 17.5%, trade bookings were approximately flat as the company is benefiting from longer term defense related orders. While headwinds in the aerospace market will continue in 2021, we do believe Arnold will show growth in revenue and EBITDA in the year as the effects of the pandemic begin to lift.

We recently rebranded Foam Fabricators as Altor Solutions to better reflect the company's diversified packaging platform. Altor Solutions grew EBITDA by 6.8% in 2020. This is partially attributable to the performance in its core business and it's also attributable to benefits from the bolt-on acquisition of Polyfoam Corporation midway through the year, which has driven strong top line growth as demand for protective packaging and temperature management solutions continue to increase. We continue to see solid demand at Altor Solutions in 2021 and are encouraged by the company's strong project pipeline.

The Sterno Group's 2020 EBITDA declined by 27.8% versus 2019 to $49.5 million. Demand for the company's core chafing fuel lines decreased significantly in the fourth quarter given the substantial reduction in holiday banquets and large gatherings. We expect this segment to slowly improve in mid to late 2021 as large portions of our population are vaccinated and business and leisure travel begin to show signs of recovery. The company's consumer business continued to experience elevated demand for [indiscernible] (00:14:54) and essential oil products. The product mix had a slightly negative impact on margins during the fourth quarter. We anticipate Sterno's results in 2021 will be in line with 2020.

Now, turning to our branded consumer businesses, which continue to benefit from ongoing consumer demand in outdoor categories. Our results are presented as if we own Marucci and BOA from January 1, 2019. For the year, revenue increased by 9.1% and EBITDA by 22.1% versus 2019. In 2020, our branded consumer businesses contributed over 60% of our pro forma consolidated subsidy or EBITDA. And in the fourth quarter of 2020, EBITDA at these businesses increased by 42.5%. BOA's full year 2020 EBITDA increased by 10.3% on roughly flat revenue. In the fourth quarter, BOA's EBITDA increased by 29% versus the comparable period in 2019 to $9.1 million exceeding our expectations. BOA experienced strong demand across several of its categories and continues to innovate in partnership with its customers.

This quarter, we were excited by the publication of results stemming from the company's multi-year research partnership with the University of Denver. Athletes in this study showed meaningful improvement in agility and speed and those wearing shoes with the Tri-Panel or Y-Wrap BOA closures showed performance improvements of between 3% and 9%. The study's findings were reported in multiple relevant publications. We remain impressed with the BOA team and the company's technology applications and we're optimistic about the company's future.

Ergobaby's 2020 EBITDA declined to $15.6 million versus $21.3 million in 2019. Fourth quarter revenue and EBITDA were impacted negatively as the company repurchased inventory of its Tula brand from an international distributor as the company refocuses that brand towards its historic direct-to-consumer roots. International orders have returned to more normal pre-pandemic levels for the first quarter of 2021, though further European or Asian lockdowns could have a negative impact. Ergobaby launched Aerloom carrier in the fourth quarter and results exceeded our expectations. The Aerloom is unique to the market, knit from post-consumer recycled polyester and demonstrates our commitment to sustainability. Ergo has several additional product launches scheduled for the remainder of 2021 which we believe will have a meaningful impact on the company's performance and will produce year-over-year revenue and EBITDA growth.

Liberty Safe's EBITDA increased to $19 million in 2020 from $10.9 million in 2019. Liberty's strong continued performance in the fourth quarter was driven by both dealer sales and sales for traditional big box customers. End market demand as well as bookings remain robust in 2021, and much of the company's production capacity remains filled into the second quarter of this year.

Marucci finished 2020 with EBITDA up $13.8 million, down just 3.1% from 2019. Revenue and EBITDA in the fourth quarter were up 12.7% and 63.8% respectively as the company continues to benefit from the launch of its CAT9 line of bats, strong sell-through of first product, and gains in shelf space at key accounts. We believe that Marucci's exceptional 2020 financial performance and a year that experienced reductions and stoppages of baseball seasons nationwide speaks to both the power of the brand and the quality of the company's leadership team and employees. The first quarter of the year typically represents a seasonally larger portion of the company's revenue and EBITDA given channel partners ship goods in advance of spring baseball season. This year, we are confident that Marucci is well-positioned in advance of the spring season, and we believe the company will benefit from what is expected to be a much more stable spring baseball season.

Velocity Outdoor's EBITDA increased substantially in 2020, up 83.2% from the year ago period. Velocity's performance was better than expected as investments made over the last several years came to fruition, and continued consumer interest in outdoor activities drove demand for the company's products. Though challenges in part of the company's supply chain remain, the Velocity team continued to deftly handle the heightened levels of demand and take market share. Current bookings and sell-through at Velocity remain strong for 2021 driven by growing participation rates and innovative new product introductions.

Finally, 5.11's full year EBITDA increased by 16.5% in 2020 and by almost 20% in the fourth quarter versus Q4 2019. Despite reduced traffic in the company's retail stores due to the pandemic, 5.11's direct-to-consumer business as a whole significantly exceeded our expectations in 2020. In addition, the company took significant steps in the fourth quarter to enhance its omni-channel retail experience as it enabled ship from store capabilities in the vast majority of its 73 retail locations and shipped a significant portion of online orders from stores during the holiday season. We continue to believe that the 5.11 brand resonates strongly with its customers and that the company has even greater opportunities ahead.

Before I turn the call over to Ryan, I would once again just like to recognize the extraordinary work of our subsidiary company management teams and all of our employees in 2020. Last year created management challenges and obstacles that no one could have envisioned 12 months ago. Throughout the year, our teams demonstrated skill, leadership and dogged determination, and we are proud to work with each of them.

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

Ryan J. Faulkingham

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

Thank you, Pat. Moving to our consolidated financial results for the quarter ended December 31, 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-K that was filed with the SEC earlier today. On a consolidated basis, revenue for the quarter ended December 31, 2020 was $474.8 million, up 22.7% compared to $387 million for the prior year period. This year-over-year increase primarily reflects our acquisitions of Marucci and BOA during 2020. Excluding these recent acquisitions, our revenue increased by more than 10% driven by strong sales growth at our branded consumer subsidiaries Velocity Outdoor, 5.11, and Liberty which offset declines in sales at Arnold, Ergo, and ACI.

Consolidated net income for the quarter ended December 31, 2020 was $8.8 million compared to $5.4 million in the prior year. CAD for the quarter ended December 31, 2020 was $36 million, up 20% from $30 million in the prior year period. Our CAD that we generated during the quarter was significantly above our expectations primarily due to our strong fourth quarter EBITDA increase as compared to the prior year. Other factors impacting our CAD in Q4 compared to the prior year include slightly lower CapEx spend, an increase in cash taxes, and higher preferred share distributions as a result of our Series C issuance in November of 2019. On a full year basis, our CAD substantially exceeded our distribution. Our payout ratio for fiscal year 2020 was 82%, and our CAD increased 6% over the prior year.

Turning to our balance sheet, as of December 31, 2020, we had over $70 million in cash, approximately $290 million available on our revolver, and our leverage was 3.1 times. We have 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 with the financial support they need, invest in subsidiary growth opportunities as well as act on compelling investment opportunities as they present themselves.

Turning now to capital expenditures, during the fourth quarter of 2020, we incurred $6.7 million of maintenance CapEx of our existing businesses compared to $7.2 million in the prior year period. During the fourth quarter of 2020, we continued to invest in growth capital, spending $4 million in the quarter primarily related to 5.11's long-term growth objectives. Growth CapEx in the prior year quarter was $5.7 million.

Turning to our expectations for 2021, 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 2021. I'd like to now provide guidance on CapEx and cash taxes. For maintenance CapEx, our estimate of spend for the full year of 2021 is between $20 million and $25 million. For growth CapEx, our estimate of spend for the full year of 2021 is between $12 million and $16 million, primarily at 5.11. For cash taxes, we expect full year 2021 cash taxes to be approximately 9% of our subsidiaries' total adjusted EBITDA. As a reminder, our cash taxes as a percentage of EBITDA can vary significantly from quarter-to-quarter.

As Elias mentioned earlier, we are continuing to explore a change in our tax structure, including the possibility of electing to be taxed as a C corporation. We are evaluating the costs and benefits of such a change as well as the implications of current and future tax law, corporate law, and potential impacts of such a change on our access to the capital markets, distribution policy, corporate debt ratings, cost of capital amongst many other considerations. We will provide updates as appropriate as we move along in this process.

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 would like to close by briefly discussing M&A activity and our go-forward growth strategy. As I mentioned earlier, we took prescient steps in 2019 to prepare for the unexpected in 2020. Those decisions and our unique permanent capital structure positioned us to not only weather the storm but to also proactively execute on our growth strategy in a volatile year. Heading into 2021, we continue to have the balance sheet strength to support our companies as they operate in these unpredictable conditions. We remain confident in our subsidiaries and their respective management teams as they have successfully pivoted their businesses as appropriate during the pandemic to maintain and even grow their market positions. As we look to the future, we're optimistic that our subsidiaries are well-positioned to continue to gain additional market share and look forward to continuing to support their growth in the months and years to come.

As for CODI, we will continue to seek both platform and add-on acquisitions as we believe that there are compelling opportunities for us to generate long-term shareholder value given continued market dislocations in 2021. 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 us apart for more than a decade, and it remains consistent. In 2021, we remain intensely focused on executing our proven and disciplined acquisition strategy, improving our 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 questions-and-answers.

QUESTION AND ANSWER SECTION

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

Lawrence S. Solow
Analyst, CJS Securities, Inc.

Q

Great. Thanks. Good afternoon, guys, and congratulations on a really good year in a tough environment. I guess first question, just a couple on the subsidiaries themselves. Just on 5.11, good to see it returning to growth in the quarter and the pipeline. Really impressed with the margin improvement in the year; I think it was up like 170 bps or so. And revenue was relatively flat, up [ph] maybe a couple percentage (00:27:41) points. But just trying to dive a little bit more into that. Is that driven by mix, more online sales, productivity gains or maybe a little operating leveraging in there? What's sort of driving that margin improvement in the year of over 15%?

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

A

Hey, Larry, it's Elias. And good afternoon and thank you for your comments at the beginning. With 5.11, I would say what is broadly not being seen by the market is the shift in the consumer and professional business. As you know, a few years back, this was predominantly a professional business. Today, it's migrated to be, in North America, more of a consumer business size-wise. The professional business had quite a few challenges globally. There was a lot of the social unrest caused police and other law enforcement budgets to be reduced. And so the pandemic has actually, I think uniquely caused the professional side to be down, and that's masking the really extraordinary results on the consumer side.

So as we've mix-shifted more towards consumer, clearly, that has much higher gross margins. And because we have such a direct presence, most of our consumer is direct-to-consumer, the margins are substantially better than they are in a wholesale business. So most of it I would say is due to mix shift. I will say the company also did an extraordinary job of moving quickly to ratchet cost down. The retail side of our consumer business experienced far lower traffic as a result of the pandemic. So the company did a great job of moving very quickly to retain profitability in the retail side. And I would say just broadly, because of the uncertainty, the company did great at controlling spend.

Now, I will say that there's a lot of opportunities for investment in this company. So as we look into 2021, and the consumer business continues to grow really dramatically, I would say we would plan to bring back some of that expense. Not necessarily deleveraging the margins, but we would plan to bring back expenses at least in line with revenue growth because there is some good opportunity to really enhance the company's growth rate over the long term.

Lawrence S. Solow
Analyst, CJS Securities, Inc.

Q

And I saw you plan to maybe accelerate the slowdown of new store openings in 2020, although I think that did start in the back half. But with your commentary on CapEx mostly going towards 5.11, I assume that's for new stores?

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

A

Yeah. And you remember with our new stores that has multi-purpose, one is clearly as a revenue. The second is it really acts as a marketing in that trade region. But third and most importantly, and Pat hit on this in his section, we now have more of a true omni channel experience and we're able to ship from store, which we did – a considerable amount of revenue from our e-com was actually shipped from our stores. So it opens up a lot of capacity. So it works so integrated, Larry, from an omnichannel standpoint that we think it's important to continue with that. And frankly, with rents coming down, the economic model is still very strong. And so I would say our commitment to continuing to rollout the store network is as strong as it was pre-pandemic.

Lawrence S. Solow
Analyst, CJS Securities, Inc.

Q

Got you. Okay. And then just switching gears on the C structure conversation. I think this often comes up, and I know you guys are – it's a continuous process and evaluation for you guys and for Compass. Is there anything, from a high level, different this time around? It does seem like perhaps maybe you're not taking this more seriously or maybe moving more towards a potential switch in structure. Have tax structures or tax laws changed at all? Perhaps under the Trump administration, it didn't change or the Biden or something along those effects. Or anything that's kind of maybe different this time around?

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

A

Yeah. So I'm going to ask Ryan to give a little bit more detail, Larry. But I would just say, kind of high level, couple things. One, the Trump tax law was negative to partnerships and the tax law change. There was just one component of it. And therefore, the differential between – and this is still early in our analysis. But the positive differential we had from being a pass-through has really materially come down based on a provision in that tax law that has changed. That's number one.

Number two, we would be looking at this really seriously anyway. And as I said in my commentary, our goal is to have the best cost of capital amongst the private equity peer set that is looking at middle market opportunities. And we think that when we – I always say to the guys we're always looking at where is the economic moat of a business and how can it continue to be deepened. We think one of the economic moats around our business is our weighted average cost of capital, and it is materially lower now than what our peers are especially on a risk-adjusted basis. Now, look, if you're going to have 90% leverage, then your WACC is probably lower, but your chances of going out of business are pretty high. And so when we risk-adjust it, we think our WACC is really low.

We are continuing to look at all opportunities that we can lower our WACC. And changing to a C corp for tax purposes has the potential, in our opinion, to lower our cost of capital. So it's getting a really serious evaluation. Now with that, Ryan, maybe you can just touch a little bit more granularly as to kind of how we're looking at this.

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

A

Yeah. Sure. Hi, Larry. One other thing just on the taxes. Of course, part of the consideration is Biden's administration and what that does for taxes. And the early preliminary analysis on that is there's – it's still net-neutral in that it's not that detrimental in terms of raising rates on corporate. So I think that's kind of a positive sign. But certainly, it is early in the process. We believe we have the right partners assisting us in the analysis. We've talked about the tax impact, what's the tax impact on shareholders, what's the tax impact on the corporation that moves forward, what's the impact on our distribution policy, what's the timing of it, and of course, what's the market impact of it. And all of that, with the line of sight on reducing cost of capital, as a sort of the paramount strategic rationale. So it's moving along. It is a long process for sure. And we want to make sure that we're thorough in the analysis.

Lawrence S. Solow
Analyst, CJS Securities, Inc.

Q

And just lastly, just a quick follow-up on that. You mentioned a potential change in the distribution policy. Can you maybe elaborate on that [ph] a little (00:34:53)?

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

A

Sure. Sure, Larry. I mean part of the analysis is trying to consider what the tax impact across the system is. And today, our shareholders, who are partners, pay the tax on our distribution. So $1.44 per year goes out to shareholder. And a portion of that is the tax liability of the entity. And if we were a C corp, then the C corp would now have a tax liability. So there has to be some analysis around what makes sense in terms of our distribution policy. And I think as Elias highlighted, our core focus is on reducing our cost of capital. So we need to think about what the distribution policy is going forward now that we assume the tax liability and how that impacts our cost of capital. So that's kind of where we're at. It's still early in that process, but that is part of the analysis that we're working on.

Lawrence S. Solow
Analyst, CJS Securities, Inc.

Q

Got it. Okay. Great. Appreciate that color. Thanks. Thanks again.

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

A

Sure, Larry. Thank you.

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

Kyle Joseph
Analyst, Jefferies LLC

Q

Hey, good afternoon, guys. I only echo my congratulations on a very strong finish to a turbulent year. I guess, I'll start out from a high level perspective just thinking about 2020 and even into 2021, the proliferation of SPACs. Can you give us a sense for the potential impacts on your business, whether positive or negative, of the proliferation of SPACs, admitting we don't know how long this phenomenon will last, whether it's temporary or not, but just kind of near term implications for the business?

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

A

Sure. Good afternoon, Kyle. It's Elias. I think the SPACs are generally not competitive [ph] for with us (00:36:46) given what they're focused on. Now, what we see is a lot of the high profile ones, but they're really geared much more towards early stage companies that want a public mechanism by which they can go public. So we're seeing the EV space, the battery space for EVs, the space, right, like with Virgin Galactic. And I think you're going to continue to see some of these companies that frankly we would have no interest in acquiring. They're pre-revenue in some cases. They're clearly [ph] pre (00:37:25) cash flow, and so that doesn't really fit in our model. Generally, lower middle market companies like we're acquiring are not ones that are highly desired by the kind of SPAC group right now. So, we don't really see competition from SPAC.

Conversely, I would say, we don't really see SPACs as a great exit opportunity for a lot of our companies either because the dynamics of what they're looking for, much earlier stage sort of much more disruptive type companies. So my view is it doesn't really have that large of an impact one way or another on us. But you're – there is a broader point I think beyond SPACs which is there is a lot of capital that continues to be in the market. As we all know, the Federal Reserve continues and central banks around the world continue to be very aggressive with monetary policy, and that continues to push people to seek higher returns out the risk curve. Ultimately, we sit at the end of the risk curve, right, in the private equity space. And so there is a lot of capital that's sitting there.

And there, I would say, the – there are some opportunities that continue to be created because there are still dislocations in certain segments of the market. But broadly, we see asset prices returning back in 2021 to where they were pre-pandemic as the simple supply and demand of capital against assets dictating that. And you can still get access to relatively cheap debt capital. In fact, maybe not relatively, but historically cheap debt capital in many instances. So the competitive dynamic not from SPACs but just from private equity likely look more like it did pre-pandemic right now.

Kyle Joseph
Analyst, Jefferies LLC

Q

Got it. Makes a lot of sense. And then, question for probably either Elias or Ryan, here, just on seasonality kind of a couple of years ago, we're accustomed to the first quarter being the lowest in terms of CAD, but obviously you had two portfolio sales and two portfolio acquisitions, so the portfolios evolved and then in 2020 you can obviously throw any seasonality out the window. But just – and I think you guys alluded to Marucci having kind of a strong first quarter, so just give us a sense for how the seasonality of the overall portfolio has evolved.

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

A

Yeah. And Ryan, do you want to – I'll kick it over to Ryan and let him talk about it. But it's likely going to be less than what it's been historically, largely because Marucci does have their strongest earnings quarter in the first quarter. But Ryan, do you want to touch on that?

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

A

Sure. Yeah. No, that's – what Elias said is spot on. Historically, our first quarter has been one of our lower cash flow generating quarters and Marucci certainly offsets that given their business and the sell-in ahead of the baseball season, so that'll help our first quarter overall. And BOA traditionally doesn't have much seasonality. Their business can be a little lumpy depending on when product gets sold in, but it's really hard – it's hard to assess seasonality on that business right now. And you're right, COVID certainly skews things a lot this year. Just given, as you say, you can throw it out the window. So I think 2021, maybe the back half may normalize a little bit. The first half could have some benefit to overall results because of COVID ending, but it's hard to read that now. But by and large, as we go forward thinking 2022, the business will be less seasonal overall.

Kyle Joseph
Analyst, Jefferies LLC

Q

Okay. And one last one for me. Apologies, Ryan, I missed it in your commentary, but minus where leverage caused the year out and how that would trend through 2021 ex-incremental acquisitions and give us a context of where that is in your overall target leverage.

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

A

Yeah. Sure. So it's just under 3.1 times at the end of the year. So that is in line with financial policy. And it's a comfortable place for us to be. The good news is as we exited 2020 we had a very high free cash flow year and we were able to organically de-lever as we exited the year. And as we look at 2021's expected performance, again assuming no acquisitions or divestitures, we'll have organic de-levering occur with that free cash flow generation. So it's certainly starting to hum I'd say given that we now have 10 businesses and we've got more core growth occurring in the portfolio. So we should definitely reap the benefit on the leverage standpoint as we exit 2021.

Kyle Joseph
Analyst, Jefferies LLC

Q

Got it. Very helpful. Thanks for taking my questions and congrats again on a very good year.

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

A

Thank you, Kyle.

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

A

Thanks, Kyle.

Operator: Your next question is from the line of Chris Kennedy with William Blair.

Cristopher Kennedy
Analyst, William Blair & Co. LLC

Q

Hey, guys. Thanks for taking the questions and congrats on navigating at difficult time. I just wanted to dig in a little bit more on the momentum in Velocity. Is there a way to parse out kind of the internal initiatives versus kind of the macro tailwinds towards Outdoor? Thank you.

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

A

Pat?

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

A

Yeah. Thanks. I think the short answer is no. But we see – we do see – we are seeing shelf space gains. We're seeing a great reaction to our product introductions. And so, we think we are taking market share. We believe strongly that we are outpacing the market. But other than that, we can't pull it apart quantitatively.

Cristopher Kennedy
Analyst, William Blair & Co. LLC

Q

Understood. And then, just a broader question on the – I think Elias, at the Investor Day, you kind of talked about potentially looking into new verticals whether it be healthcare or fintech, or something to that effect. Can you just go a little bit more into that, would be great. Thanks a lot, guys.

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

A

Yeah. So, we continue and it really gets back to sort of the strategic look of our business. And as our cost of capital continues to come down and our competitive advantages continue to grow, we think the business is poised for a good kind of growth spurt here going forward. We've been developing our human capital internally, and I think our team right now is operating at a level that frankly is better than we've had in any year. And look, it's evidenced by what we did last year, right? A couple of acquisitions, a couple of CEO transitions that we completed, doing some capital raising, those are all really positive and the financial results we deliver I think are a testament to the entire group with the manager who all performed at such an extraordinary level.

Now, that all being said, we look at a lot of the stars aligning for growth, but we don't have core expertise and some additional verticals. And so, our ability to enter into new verticals is really predicated on us finding the right human capital and bringing that aboard. I think I mentioned at our Investor Day don't expect this to be something that is kind of a near-term 2021 objective that we can execute against. Maybe if we found the right person, my personal guess is it's longer than that, because we're going to want to build around some talent that we bring into the organization. So we continue to recruit and get really high caliber individuals that are coming into the firm, and really all plays I think together, Chris, in terms of how we look at our kind of growth mandate going forward. But entering into new verticals without brains and talent that has that domain expertise we think would be all too risky.

And so we're going to just be more patient, wait till we find the right person. We will clearly announce that when we do to the marketplace. And then from there, there's some length of time until we would be active in that space. But that's sort of the sequencing of it. I would again reiterate, I want to consider that a near-term objective. We would be fortunate if it is. But I don't think it's kind of near-term that we can execute against that.

Cristopher Kennedy
Analyst, William Blair & Co. LLC

Q

Great. Thanks a lot, guys. Take care.

Operator: Your next question is in the line of Matt Koranda with ROTH Capital Partners.

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

A

Hey, Matt.

Gus Galá
Analyst, ROTH Capital Partners

Q

Hey, it's Gus stepping on for Matt. Just wanted to talk – unpack Marucci and Velocity's EBITDA margins a little more. Those are pretty outstanding. Just wanted to see if you could talk more to what drove that. Thanks.

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

Yeah. I'm going to ask Pat to comment on both Marucci and Velocity for you.

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

Yeah. I'd say if you kind of look annually, we definitely had some reduced costs. I would look to be investing in both those businesses. I just think the opportunities in both those businesses are plentiful. All those being said, I don't see EBITDA margins progressing significantly at either of them.

Gus Galá
Analyst, ROTH Capital Partners
Q

Got it. That's helpful. And I guess just to wrap-up, so with – for Altor Solutions ,I know that you guys are distributed across like a dozen plus locations. Just any concerns with the weather, with Texas weather, and being able to get the raw materials?

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

Sure. So broadly speaking, several of our plants were down for brief periods. They are now all back up and functioning at or close to full capacity. As it relates to raw materials, we're looking kind of through the supply chain back to sort of [ph] polystyrene (00:47:58) prices. There are some disruptions. We believe we're in a good position versus our competitors. We believe any disruption will be somewhat minor. And as you know, we have price pass-through mechanisms with a lot of our customers as well. So we don't see any shortages. There may be raw material increases because of the disruptions, which we think we'll be able to handle those.

Gus Galá
Analyst, ROTH Capital Partners
Q

Great. Thanks, guys.

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

Thank you.

Operator: Your next question is from the line of – I'm sorry if I mispronounced your last name – Matt Tjaden with Raymond James.

Matthew Tjaden
Analyst, Raymond James & Associates, Inc.
Q

Hey, all, afternoon and thanks for taking my questions. Just wanted to follow-up if I can. Any color you can give on where valuations are sitting now versus kind of pre-COVID levels? And then how are you thinking about positioning in 2021 whether that's net buyer, net neutral or net seller? Thanks.

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

Yeah. I'm going to let Pat just touch on valuations because he's seeing companies within the market on a daily basis. I would say with respect to our view on 2021, it's a little hard to tell whether we will be a net divestor or a net kind of investor here. I would say over the next couple of years, because we believe we are at the beginning parts of a cycle, being a net investor is likely where we would like to be. Although as you know, along the way, we're always open to opportunistic divestitures. And so whatever the market kind of gives us is what we look at taking advantage of for our shareholders. And it's hard for us. We really don't comment on whether we're going to divest a business or we're going to acquire a business. But I would say in general, we're probably looking to being net investors over the next couple of years. Pat, any commentary on what you're seeing in kind of asset valuations both from an absolute standpoint and a multiple basis?

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

A

Yeah. I mean I'd say the – we're back to pre-pandemic levels, if not, above them. Our challenge – some businesses have been sort of – there's been a change in consumer patterns that have permanently changed the way consumers operate and work because of COVID. And so you can kind of capitalize those earnings. Other times, there's things that you have to look for to see what's the 2021-2022 EBITDA really going to be like before you put on multiples. And that's sort of the process that I see the market is going through right now, if that makes sense. But in a sort of vacuum, average multiples are back up sort of above pre-pandemic levels. And then then it gets into the minutia of business to business.

Matthew Tjaden
Analyst, Raymond James & Associates, Inc.

Q

Great. That's it for me. I appreciate your time.

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

A

Thank you.

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

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

Great. Well, 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. We look forward to sharing our progress with you in the future. That concludes our call. Thank you.

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