29-Jul-2021

Compass Diversified Holdings, Inc. (CODI)

Q2 2021 Earnings Call

CORPORATE PARTICIPANTS

Matthew Berkowitz
Director, The IGB Group

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

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

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

OTHER PARTICIPANTS

Larry S. Solow
Analyst, CJS Securities, Inc.

Matt Koranda
Analyst, ROTH Capital Partners LLC

Kyle Joseph
Analyst, Jefferies LLC

Cristopher Kennedy
Analyst, William Blair & Co. LLC

Derek Hewett
Analyst, BofA Securities, Inc.

Matthew Tjaden
Analyst, Raymond James & Associates, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and welcome to the Compass Diversified's Second Quarter 2021 Conference Call. Today's call is being recorded. [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
Director, The IGB Group

Thank you and welcome to Compass Diversified's second quarter 2021 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 Q2 2021 press release, including the financial tables and non-GAAP financial measure reconciliations, are available at the Investor Relations section on the company's website at www.compassdiversified.com. The company also filed its Form 10-Q with the SEC today after the market close, which includes reconciliations of non-GAAP financial measures discussed on this call and is 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; and statements related to expected divestitures of Liberty and CODI's future tax structure. Words such as believes, expects, plans, project, 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-Q as filed with the SEC for the quarter ended June 30, 2021, 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 company. 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 second quarter earnings conference call. Before we get started, I'd like to take this opportunity to thank all of our employees for their extraordinary efforts, which continue to impress me as we navigate further through this unprecedented times. We've exited 2020 with strong momentum, and that has carried over in 2021. Before we turn to the financial performance for the quarter, we want to provide an update on our busy start to 2021 and the significant progress we have made against our strategic alternatives.

During the second quarter, we took significant steps towards our potential tax reclassification. We have set a date for our special shareholders' meeting which will be held on August 3rd, and we will announce the results of our special proxy vote as soon as practical, following that meeting. If we receive approval from our shareholders, we expect our board will seek to effect the tax reclassification as soon as practicable.

We are excited about this potential change, which we believe would present an opportunity to expand CODI's shareholder base and make our company more widely accessible. We believe this would position us to further build on our 15-plus years of success as a public company and provide greater value for all shareholders over time.

Subsequent to the second quarter, we announced the execution of a definitive agreement to divest Liberty Safe, which we expect to close in August of 2021. I want to extend a special thanks to the management team and employees of Liberty Safe for 11 years of successful partnership with us. During this time, we established both a strong personal and professional relationship, while delivering a solid return on invested capital that exceeded our initial underwriting expectations. I wish the Liberty team success with their new partners as they embark upon the next stage of their journey.

Earlier this year, we also completed a debt refinancing that significantly lowered our interest costs, further reduced our weighted average cost of capital, and strengthened our capital structure. This is a key example of how our team is always looking for more efficient ways to tap into the capital markets. As a result of our actions in March, we believe today we are better positioned to continue to leverage our permanent capital structure to our advantage as we look to be opportunistic in the market.

And, finally, before I turn to financial performance, I want to mention that we have initiated a process to preliminarily explore strategic alternatives for 5.11, including a potential initial public offering. We trust you will understand that, in light of this, we will not be able to take any questions on 5.11 today.

Now, turning to our financial performance. I am pleased to report that our second quarter results continued the trend of outperformance that we saw on the first quarter. Including BOA and Marucci as if we owned them from January 1, 2020, pro forma consolidated revenue grew approximately 36%, and adjusted EBITDA grew approximately 63% over prior year's quarter.

Our second quarter results were exceptional and reflect the incredible work of each of our subsidiary companies' management teams. While we continue to experience certain challenges and uncertainties stemming from the pandemic – such as changes in demand patterns, supply disruption, shortages in labor, and inflationary pressures at that levels not previously experienced – our subsidiaries teams continue to expertly manage their operations to deliver record results.

Our branded consumer businesses continued to grow at an accelerated rate. With all six of our branded consumer businesses growing revenue and EBITDA at a double-digit rate, producing second quarter aggregate EBITDA growth of approximately 100% over the prior year. This growth was significantly above our expectations; however, it is important to point out that our second quarter growth rate is distorted due to the base effect from last year when the economy went into shutdown.

Our consumer businesses started posting accelerated growth in third quarter of 2020, which is carried through this quarter. As a result, we expect the growth rate of our consumer businesses to normalize going forward as we have higher prior-year comparables.

Following on the trends experienced in the first quarter, our industrial businesses posted second quarter revenue and EBITDA growth of 24% and 18%, respectively. These results, which also exceeded our expectations, reflected quicker return of demand for Sterno and Arnold, our businesses most impacted by the pandemic.

Notwithstanding the outperformance in the first half, I want to emphasize that the macro environment remains uncertain. While demand across our subsidiaries remain strong, significant challenges exist, particularly on the supply side; inflationary pressures remain elevated and supply constraints are acute.

We were very pleased that our margins in the second quarter held up remarkably well, despite these pressures, and believe this is a testament to the strength of our subsidiary management teams. Going forward, we expect some margin headwinds in the third quarter, as higher input costs start to flow out of inventory and into our cost of goods sold. These extraordinary conditions are creating a backdrop where our subsidiaries, like many others, are raising prices in order to combat rising inflationary pressures.

Emerging from the pandemic has created a fluid environment that makes forecasting future results more difficult than in past periods. Amongst the difficulties are uncertainty over demand pattern changes, supply shortages, labor tightness, and inflationary pressures. That said, in light of our extraordinary first half results and our expectations for the balance of the year, we now expect to produce full year 2021 consolidated subsidiary adjusted EBITDA of between $350 million and $370 million, which includes Liberty, representing growth of 20% to 27% from prior year; and a payout ratio of between 65% and 55% based on [ph] our (00:10:09) historic distribution rate of $0.36 per share each quarter.

If we exclude Liberty's adjusted EBITDA from our 2021 full year estimate, as the sale is anticipated to close in August, we would expect to produce between $325 million and $345 million of consolidated subsidiary adjusted EBITDA. I would also like to note that our guidance incorporates onetime expenses and write-off at Sterno of up to $5 million in the back half of 2021, as the company exits a low margin product line. As a reminder, we do not add back extraordinary costs in our result. Excluding this charge and with the economic recovery underway, we believe the company will continue to show positive comparison in the back half of the year.

Before turning the call over to Pat to review our subsidiary results, I would like to take a minute to discuss our ongoing ESG efforts. CODI is deeply committed to maintaining responsible investment practices that position our businesses and our firm for long-term success, and positively impact the world around. I am proud to report that during the second quarter, we became a sponsoring member of US SIF: The Forum for Sustainable and Responsible Investing. US SIF is the leading voice in advancing sustainable and impact investing across all asset classes. We believe joining the US SIF strengthens our commitment, and we look forward to being an active participant in The Forum.

Also, during the second quarter of 2021, we added two independent board members to BOA's board of directors; while last year we added two independent board members to Marucci board, solidifying our commitment to good corporate governance, both at the CODI and the subsidiary level.

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

Patrick A. Maciariello

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

Thank Elias. Before I begin in our subsidiary results, I want to talk generally about the quarter. We believe our branded consumer businesses remain very well-positioned to benefit from the changing consumer landscape. Each of these businesses exceeded our expectations in the quarter.

As a group, our niche industrial businesses also performed above expectations. With that said, I also want to reinforce what Elias said about today's dynamic environment. All 10 of our subsidiaries experienced significant increases in costs in the quarter, and many of them face supply chain disruptions. Our management teams showed tremendous skill and adjusting on a real-time basis to the fluid conditions, and they once again affirmed the strong confidence we have in them.

Now, on to our subsidiary results; I'll begin with our niche industrial businesses. For the second quarter of 2021, revenue increased by 24.1% and EBITDA increased by 18.4% versus second quarter of 2020. On a year-to-date basis, revenues increased by 13.6% and EBITDA increased by 10% versus 2020.

For the year-to-date period, revenue at Advanced Circuits was approximately flat and EBITDA declined by 3.4% as compared to the first six months of 2020. Once again in this quarter, bookings outpaced billings, and ACI has built up considerable backlog due parts shortages, mostly in its assembly business.

Arnold Magnetics' revenue increased by 20.8% and EBITDA increase by 47.2% to $9.8 million in the first six months of the year. The increase was driven by several factors, including increased sales to aerospace and defense related customers associated with large orders received in 2020; higher gross profit margins associated with positive mix; and the acquisition of Ramco, which was completed on March 1st of this year.

Arnold met our expectations for the quarter, despite order volume in the company's aerospace segment not yet returning to pre-pandemic levels. As this market segment normalizes in the remainder of 2021, we expect that Arnold's performance will materially outpace a weaker back half of 2020.

Altor Solutions grew revenue by 48.6% and EBITDA grew by 12% in the year-to-date June 2021 period as compared to the same period in 2020. As we forecasted last quarter, margins were under pressure in the second quarter due to significant increases in the company's core raw material. In addition, margins continue to be impacted by the acquisition of Polyfoam in Q3 2020, which carries lower margins. We expect margins to improve for Altor for the remainder of the year, as the company is able to contractually pass through a substantial portion of its raw material price increases. We also expect performance improvement measures at Polyfoam to progress following pandemic-related delays.

The Sterno Group's year-to-date revenue and EBITDA increased by 3.9% and 5.8%, respectively, versus year-to-date 2020. Demand for the company's core chafing fuel lines continue to increase sequentially as travel and events slowly return to normal. Though improving significantly, the company is not yet seeing foodservice demand at pre-pandemic levels. Demand for Sterno's consumer products remains solid, and the company continues to see strong demand for its line of wax and essential oil products.

As Elias mentioned, in Q3 and Q4, we will have restructuring expenses totaling $4 million to $5 million at Sterno, as the company exits a lower margin product line. Excluding these expenses, we believe Sterno will continue to show positive comparisons in the back half of the year, absent new pandemic-related mandates being put in place.

Now, turning to our branded consumer businesses, which as the group experienced another exceptional quarter. Our results are presented as if we owned Marucci and BOA from January 1, 2020. For the quarter, each of our six branded consumer businesses exceeded our expectations and experienced significant growth. As a group, year-to-date revenues increased by 38.7% and EBITDA increased by 19.3% versus the year-to-date period in 2020.

BOA's year-to-date revenue increased by 57.8% versus the comparable period in 2020. EBITDA more than doubled to $32.2 million versus the comparable period in 2020, exceeding our expectations. BOA continues to experience strong demand across most of its categories led by cycling, workwear, and snowboard customers. In addition, the company's partners in trail running launched several new innovative products during the quarter which were met with excitement in the market.

We continue to believe that some portion of BOA's exceptional growth stems from brand partners ordering ahead due to supply chain constraints associated with slowdowns in global shipping. We believe the company will perform well and continue to grow in the back of 2021, but we do not expect the same level of explosive growth that we have experienced year-to-date.

BOA's growth so far under our ownership has been exceptional. While the company is not immune from supply chain challenges and delays, particularly given their growth, management is definitely working through these issues. We are working well with the team at BOA at all levels, and are pleased to have developed a strong trust and solid relationships. We're excited about the company's future and are proud to be partners with the team there.

Ergobaby's year-to-date 2021 EBITDA increased to $11.1 million versus $8.9 million in the year-to-date period of 2020, an increase of 24.1%. The company has experienced strong demand for its Omni Breeze carrier, which started shipping in the first quarter of this year, as well as strong sales generally online. We feel like the company has achieved an inflection point in performance and remain optimistic about Ergobaby's prospects in the back half of 2021. That said, Ergobaby is one of our most global businesses, and as such, continued lockdowns in a number of countries could impact its growth in the remainder of the year.

Liberty Safe's year-to-date revenue and EBITDA increased by 31.4% and 66.5%, respectively, compared with the prior year-to-date period. As Elias mentioned, we have entered into a definitive agreement to divest Liberty Safe, which we expect to close in August; and I would just like to take this moment to personally thank the employees and management team of the company for over a decade of partnership.

Marucci had another strong quarter that exceeded expectations. It's important to note however, that comparisons benefited from a severely impacted second quarter in 2020 when team sports were almost completely halted due to the pandemic. Revenue in the year-to-date period grew by 120% and EBITDA increased dramatically to $17.7 million versus $3.2 million in the prior year-to-date period.

Marucci did have certain operational inefficiencies this quarter, and we expect margins to improve from second quarter levels in the back half of the year. The third quarter represents a tough comparable for the company, as Q3 2020 represented an opening up of team sports, and the company launched the highly successful CAT9 line of bats. That being said, we believe the company and its brand are on solid footing and will have a strong back half 2021.

Of note, I would like to mention that this last weekend represented the return of the Marucci World Series, in which 120 premier youth baseball teams traveled to Louisiana to compete on playing fields throughout the state. We are excited that this event returned following the pandemic. By all accounts, it was a tremendous occasion that signaled a strong return for youth baseball following a canceled season.

Velocity Outdoors' EBITDA increased significantly in the first half of 2021, up 136.7% to $24.8 million. Velocity's performance surpassed our elevated expectations as consumer interest in outdoor activities continue to be strong and drove demand for their products. Bookings in the quarter were higher than they were in the second quarter of 2020, despite the company having a very strong quarter a year ago, and backlog remained to close to record levels.

While we are not certain to what degree the permanently shifted consumer behavior toward outdoor activities, we do believe that Velocity captured significant market share in both of its main segments over last 18 months. Though challenges continue in part of the company's supply chain and they are not immune to commodity price increases, we believe Velocity will have a solid back half 2021.

Finally, 5.11's year-to-date EBITDA increased by 41.7% versus year-to-date 2020, and revenue grew by 14.4% over the same period. As a reminder, due to the process we have initiated at 5.11, I won't be delving further into the specifics of 5.11's performances.

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 & Member-Investment Committee, Compass Diversified Holdings, Inc.

Thank you, Pat. Moving to our consolidated financial results for the quarter ended June 30, 2021, 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 June 30, 2021 was $487.4 million, up 46.1% compared to $333.6 million for the prior year period. This year-over-year increase primarily reflects our acquisition of BOA during 2020. In addition, we had strong sales growth at our branded consumer subsidiaries and our niche industrial businesses on a combined basis.

Consolidated net loss for the quarter ended June 30, 2021 was $11.3 million compared to $7.4 million in the prior year. The increase in net loss was due to a $33.3 million loss on debt extinguishment recorded during the second quarter of 2021 as a result of our bond refinancing.

Cash flow available for distribution and reinvestment or CAD for the quarter ended June 30, 2021 was $46.6 million, almost 3.5 times the prior year period of $13.5 million. Our CAD that we generated during the quarter was significantly above our expectations, almost doubled our distribution, and was the highest quarterly CAD we've ever generated. The increase was primarily due to the outstanding performance at our most recent acquisitions, Marucci and BOA, as well as continued strong performance at virtually all of our consumer industrial businesses.

Other factors impacting our CAD in the second quarter compared to the prior year include slightly higher CapEx spend, an increase in cash taxes, higher management fees as a result of our waiver in the second quarter of last year, and higher interest expense.

Turning to our balance sheet. As of June 30, 2021, we had over $100 million in cash, approximately $600 million available on our revolver, and our leverage was approximately 2.6 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 and act on compelling investment opportunities as they present themselves.

Turning now to capital expenditures. During the second quarter of 2021, we incurred $6.1 million of maintenance CapEx of our existing businesses, compared to $3.3 million in the prior year period. The increase was primarily results of the need for increased maintenance spend at many of our subsidiaries, to keep up with elevated demand levels.

During the second quarter 2021, we continued to invest in growth capital, spending $4.1 million in the quarter primarily related to 5.11's long-term growth objectives. Growth CapEx in the prior year quarter was $3.1 million.

Turning now to an update on our tax reclassification process. As we've mentioned on prior calls and Elias referenced earlier, we are pursuing a potential change in our tax classification. On June 23, 2021, we issued a definitive proxy statement requesting shareholder approval to amend our governing documents, to allow the trust to check the box to elect to be treated as a corporation for US federal income tax purposes.

The shareholder meeting will be held on August 3, 2021. If the amendments are approved, we anticipate that our Board of Directors will cause the trust to elect to be treated as a corporation for US federal income tax purposes, effective late in the third quarter of 2021 or early in the fourth quarter of 2021.

We will provide an update on the results of the shareholder meeting as soon as reasonably practical, following the conclusion of the August 3 meeting. Please refer to the definitive proxy statement filed with the SEC on June 23, 2021 for additional information related to the potential tax reclassification.

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. In 2020, we took advantage of market conditions and acquired two outstanding platform companies with exceptional growth prospects. And early in 2021, we consummated an add-on for our Arnold subsidiary.

As we stand today, market conditions have changed rapidly. Asset prices have appreciated materially, driven by an increase in M&A activity stemming from an abundance of equity capital, coupled with strong availability of debt capital. Despite the frothy market, CODI remains well positioned to succeed. Our permanent capital structure allows us to be flexible and take advantage of market condition. In addition, the dramatic reduction in our cost of capital over the past few years allows us to be selectively aggressive on acquisition opportunities that we deem have potential to enhance shareholder returns.

Going forward, we will continue to invest in and enhance our subsidiary company's competitive positioning, which includes supporting them as they build and grow their digital transformation strategies. Our differentiated strategy has set us apart for more than a decade, and it remains consistent. In 2021, we will continue to be intensely focused on executing our proven and disciplined acquisition strategy, improving the operating performance of our companies, enhancing our commitment to ESG initiatives across our portfolio, and creating long-term shareholder value.

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

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Our first question comes from Larry Solow of CJS Securities. Your line is open, please go ahead.

Larry S. Solow

Analyst, CJS Securities, Inc.

Q

Great. Good afternoon, guys. Thanks for taking the questions. Elias, perhaps just a general question, kind of a lead-in – can you kind of give me a lead-in on your closing comments there. Just in terms of the pending reclassification, tax reclassification. And what do you see as sort of the advantages or – to that switch beyond sort of the obvious that it does create the target investor base and lowering the cost of capital? So does that perhaps make you more aggressive in future growth strategy, maybe try to make your site even bigger with this access to lower cost of capital. Then you can sort of just discuss that from a high level, any potential changes there, any potential changes on the capital structure, even thought to that would be great.

Elias J. Sabo

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

A

Sure. And thanks, Larry, for the question, and nice to talk to you this afternoon. So when we embarked on this process and started reviewing the entire tax reclassification, obviously, the first thing that we had to – the look-through was holistically, is there going to be a bigger tax burden as a result of this or not. Fortunately, based on some tax law changes in 2017, we found that the tax burden was the same holistically, whether we were a C-corp taxpayer or a pass-through.

So the principal benefit of being able to do this, as you've identified, is it really opens up the aperture of the number of investors that can access our company, ETFs are largely unable to given the pass-through characteristics, K-1, the unrelated business taxable income that we create. There's a lot of retirement accounts. And frankly, more and more institutional potential owners are choosing not to invest in pass-through-type entity. So, without having a negative from a tax standpoint but getting the benefit of having additional shareholders. As we've talked to investors about this during the proxy, it's sort of a no-brainer, it's all benefit without kind of any cost associated with it.

I think there's some secondary and tertiary benefits, Larry, that we're informed right now. I think we would like to move eventually towards a concept of an adjusted EPS and away from probably CAD. There'll be an overlap period so that we get comparability, because we want this to be completely transparent. But I think that helps with a few things, owning public companies like we did with FOX years ago. As you remember, one of those challenges with CAD is because we were getting the cash flow from a public company, it really put a lot of pressure on us to sell that asset and redeploy it into something that got a cash flow going forward as we migrate to a more adjusted EPS, which is, I think, also more easily understood and digested by the investor community [audio gap] (00:30:42)

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Absolutely.

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

A

Now, to your question about kind of our growth initiatives, we've been very transparent in saying we think this company operates better as a bigger entity. We think that in the next kind of 7 to 10 years, this should be $1 billion EBITDA company. And being able to get there, we're not going to get there only through organic growth and through use of debt capital. Clearly, we don't have that kind of leverage ability, nor would we want to take that kind of risk. So we will need access to equity capital, and we think this helps to provide significantly greater depth to the equity capital market that we otherwise wouldn't have had in a partnership structure.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Got it. That's a great answer. Switching gears real fast. I had actually a question on – I was going to ask you about labor availability and supply chain issues, but you've touched on that pretty extensively. Just tying that in with sort of your guidance, it appears like you certainly raised your outlook for the year. It looks like most of the raise, I know you don't guide to the quarter, but looks like most of the raise is from the beat in the quarter or the difference from your expectations. And without getting into specifics, is that sort of – am I in the right ballpark here, and you're kind of holding the line in the back half of the year just because of these uncertainties with labor and supply chain issues? And who knows what actual demand, the trajectory of demand as COVID is still kind of waxing and waning. Is that a fair assessment?

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

A

Yeah, Larry, I think that's spot on. I would say we were, frankly, pleasantly surprised by the strength of our second quarter results. And...

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Right.

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

A

...there's just a lot of uncertainties I heard from other companies. None of us have ever gone through a pandemic and a reopening of the economy. And what that portends for our businesses is very much uncertain. And as you know, we strive to [ph] get (00:32:45) reasonable guidance that we can beat.

And so, we tend to be somewhat conservative when we look at kind of where our guidance is. We wanted to – and I think we said in our scripted comments, demand is not the issue. Now, there are certain companies like Sterno or Arnold in the aerospace division where, frankly, we would like more demand, and we have the capacity to supply more demand.

But broadly across the portfolio, we have demand that remains in excess of what we can supply. And so, what we are seeing are some of the inflationary elements come through. We've talked about, and we said in our script, like other companies, we're passing on price. But it's too early right now for us to understand with any clarity what the elasticity of demand is, whether some of those price increases that are meant to protect margin are going to hurt future demand.

And so when we're in these inflection points that we feel like right now, I mean, if you went back over time, I would say over the last pretty much 15 years that we've been a public company, for the vast majority of that, we've sat in a disinflationary environment. And so, we're at an inflection now where we're seeing inflation come in, we're seeing a lot of supply constraints come in. This is something unusual to the past 15-year operating environment we were in. And so, we're choosing to be way more conservative in the outlook that we have and sort of hold where our guidance is, just because we don't know how that is all going to play out.

Now, that being said, I'll continue to reiterate, where we stand through the month of July, so one-third through the quarter, demand is holding up remarkably well, in fact, probably in excess of what our expectations are thus far in July. And if that continues, I think, we feel pretty good about the remainder of the year.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Great. Great. So just last question. [indiscernible] (00:34:51) subsidiary question. I was going to be on 5.11 [ph] after you took that (00:34:54) great number, but we've kind of been stifled there. So just [indiscernible] (00:34:58) on Sterno, just to clarify. Did you say that was a $5 million hit to EBITDA or to sales? I think you said EBITDA. And is that product from Sterno Home?

[indiscernible] (00:35:09)

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

A

There is a piece of our Canadian operations that we're restructuring and [indiscernible] (00:35:16) I think the accounting rules, [ph] it (00:35:19) can't be a onetime charge anymore. But if there will be a sort of extraordinary expense in the back half of the year, that EBITDA of $4 million to $5 million.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Got it. Okay, great. Appreciate that. Okay, guys. Thanks again.

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

A

Thank you, Larry.

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

A

Thanks, Larry.

Operator: Our next question comes from Matt Koranda of ROTH Capital. Your line is open, please go ahead.

Matt Koranda
Analyst, ROTH Capital Partners LLC

Q

Hey, guys. Good afternoon. Thanks. I don't want to get too far down the road here, but if we think about sort of the situation post tax reclassification, just wanted to get your preliminary thoughts on sort of how should we be thinking about tax expense post checking the box, if and when we get to that point.

And then, also, you mentioned probably the ability to present more of an adjusted EPS figure on a go-forward basis. So I just want to give you the opportunity to maybe talk a little bit about how you envision sort of presenting that, what are some of the elements that will go into it, how is it going to compare to CAD.

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

A

Okay. Hey, Matt. I'll touch on the tax question. With respect to the second question, I think we're still developing that. And I think internally, we're working through that, but the plan is to provide more color on the next earnings call. And then potentially come out with comparable periods and provide some depth so that people can see trends and things. But that'll be a little bit TBD for now.

But with respect to your question on income tax expense, just to take a step back to the structure, all of our companies down below are C-corp, they're all taxpayers. So the only income that is coming up to CODI is primarily interest income, because we're their lender and they're paying us interest as their lender. And that is offset though with interest expense at CODI. And, Matt, if you look at the subsidiaries we have and the interest income and the interest expense we have, that's going to be going forward, at least initially, to be in a negative position, okay? So we'll have more interest expense at CODI's level than we have interest income, okay?

And then the other income streams would be dividend income, if we have some sort of recapitalization of a subsidiary or capital gain tax, if we were to sell a business for a gain.

So in a year that we don't have a recap or a sizable capital gain, we're going to be in an NOL position, okay? So it's really, we'll be building a benefit in a given year that can then be applied on a future period should we have taxable income, okay? So, I think, it's always hard to know when we'll have a sale or a recap. But I think from a modeling standpoint, you shouldn't think about us having actual cash tax expense at the CODI level, going out the door until we have one of those two income events. Does that make sense?

Matt Koranda
Analyst, ROTH Capital Partners LLC

Q

Okay. Yes, totally, very helpful. And then maybe one for Elias just on M&A. I know at the end, you sort of talked a little bit about your views. And maybe my interpretation is you sounded a little bit more cautious on deployment of cash for acquisitions kind of given the environment we're in, multiples expanding and whatnot. So am I hearing that right? And then, are you seeing any pockets that are still interesting? Maybe just a little bit more color on where those interesting opportunities may lie, if there are any for deployment.

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

A

Yeah, Matt. So, the M&A market came back with vigor. And I would say it was probably the shortest period where you could deploy at attractive prices in a recession [ph] that (00:39:10) I've experienced. And I think it was just a function of if you think of all the capital that's sloshing around in the market. I think we all are aware, [ph] there is this SPAC (00:39:21) that had been raised at a kind of a massive level. And they have timelines, they need to deploy capital, private equity is flushed with capital, and debt availability has come back and come back more aggressive than it was at the end of the back cycle.

So all of that is just creating an enormous amount of demand for the assets. Now, we are seeing a lot more assets come to market, right? I mean, it's kind of the natural working of the marketplace. If you have demand for something, eventually, prices go up and supply comes in. But we are just seeing elevated kind of pricing based on these dynamics, and we expect that to continue.

So as we did with the Liberty Safe divestiture, we're always looking for ways to take advantage for our shareholders, even if it means we may have a short-term under-optimization of our balance sheet. So, if you look at it over a longer period of time, I think being able to capitalize on market condition is always kind of what we strive to do. And right now asset pricing is high.

So what it boils down to is, are we looking to deploy capital? You heard in the comments to Larry, our growth goals are to get to $1 billion of EBITDA. We guided $350 million to $370 million for this year, and that includes Liberty Safe, which is going to be running out. So to get from here to there, we're going to have to deploy, and we're going to have to buy new companies. I would say we continue to focus on add-on opportunities. There's some good opportunities for some of the more subscale companies that are there, where we have a platform, where we can create some cost-saving opportunities through consolidation or some revenue synergies.

And then on top of that, we're always open for a new platform. And I think, importantly, where we stand today versus years ago, and we've continued to beat on this over and over and over again, we have the best cost of capital, we believe, of any of our peers in the middle market private equity. And as a result of that, we can reach and we can get in and be the winning buyer on the really premium assets.

I think, for us, it's about finding those really great opportunities and being able to run hard against those, and now having the cost of capital that allows those to be accretive right away versus before trying to reach for some of the more premium assets would've created a dilutive near-term outlook, and that was something that would be difficult for us to absorb.

So we feel we're just fundamentally positioned so much better. But just to be more succinct in your answer, yeah, it is a market that favors divestitures now more so than it favors deployment of capital. But our business and our teams are to go out and find great opportunities to get capital deployed. So I don't want to make it sound like we won't be seeing new assets that we're acquiring both on platform and add-on, we absolutely will be; it's just our teams are working harder to be able to find those opportunities.

Matt Koranda
Analyst, ROTH Capital Partners LLC

Q

Makes total sense. Thanks for all the detail. Maybe just in keeping with the theme of asking a second question. Pat, you mentioned that BOA was on a pretty strong run rate since you guys bought it and that we shouldn't necessarily count on that growth rate to kind of sustain through the back half of this year. So just wanted to get a little bit more granularity on that, what drove the stronger than expected growth rate as well in the first half and then what sort of woes and headwinds you're contending with in the back half of the year.

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

A

Sure. I mean, as I mentioned, we've had an explosive first half, right? I mean, I think we grew by 100% or sort of double. For us to forecast that in the second half I don't think would be appropriate. Honestly, we had a stronger back half last year than we had this year. I do think we'll grow in the second half of the year. I think we'll have nice growth; we see continued demand.

We have some worry that there's a whole restocking aspect. Our covers were bared in certain of our categories, and some of our OEM partners are doing that. We have some worries that they were – that there was some ordering ahead because some of our partners were worried about the supply chain disruptions. But all that being said, we still see strong demand. We do see supply chain issues just like we do in every other business, but our management team is working definitely through that.

We believe we're taking market share and we believe we have a great product and a great technology that the company has developed and it's just sort of catching on. And it's a really global business, right? So a lot of it may not be as visible to us here in North America. But we're very confident in the back half but we just don't think we're going to quite see those growth rates that we saw in the first half as they were pretty stupendous.

Matt Koranda
Analyst, ROTH Capital Partners LLC

Q

Fair enough. Thank you, Pat. I'll jump back in queue here. Thanks, guys.

Operator: Our next question comes from Kyle Joseph of Jefferies. Your line is open. Please go ahead.

Kyle Joseph
Analyst, Jefferies LLC

Q

Hey. Afternoon, guys. Congrats on a really good quarter, and thanks for taking my questions. I'll start. Ryan, I think you said it but I missed it. Where is leverage currently? And then kind of can you give us a sense where you expect that to be pro forma the Liberty sale?

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

A

Yeah, sure. Kyle, thanks for the question and appreciate the nice comments. It was a great quarter. So we ended leverage at the end of March just below 3 times, kind of 2.9 level. We've come down to 2.64 times I believe is the exact number, and that's all through organic deleveraging. I mean, that was just truly through cash coming to our balance sheet through working capital optimization but also extraordinary EBITDA performance, so really good organic deleveraging.

The Liberty proceeds, once we receive them, as you might've seen in that release, a portion of that will be earmarked to our anticipated special distribution when we check the box, but the delta of that will sit on the balance sheet as cash. So we do not have any pre-payable debt right now, right? We got nothing outstanding on the revolver and just the outstanding bond. So it will sit as cash on our balance sheet as we seek to deploy it, but that will bring our leverage down another sort of tenth, I'd call it. So the expectation is to be sort of closer to 2.5 times I'd say by the end of the third quarter.

Kyle Joseph
Analyst, Jefferies LLC
Q

Great, thanks. And then just a follow-up for me as we're modeling out the companies for 2022. Any companies you'd highlight as being insulated from whether it be supply chain disruption or inflationary pressures? And any companies you expect to kind of be more exposed, if you will?

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

I mean, I think we see supply chain pressures everywhere, right? I mean, those that are – so I guess it's broad and it's just a matter of degree, right? But again, most of our companies are positioned in a way to where they can have a good chunk of that [ph] growth (00:47:09), and they're working hard to do that. So it's just a matter of degree, but they're all facing and probably the entire economy.

Kyle Joseph
Analyst, Jefferies LLC
Q

Got it. Yeah, totally fair. It's kind of like asking to pick your favorite child, so understood and thanks for answering my questions.

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

Thank you, Kyle.

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

Thanks, Kyle.

Operator: Our next question comes from Chris Kennedy of William Blair. Your line is open, please go ahead.

Cristopher Kennedy
Analyst, William Blair & Co. LLC
Q

Hey, guys. Thanks for taking the question and a lot of exciting things happening. Elias, can you just talk a little bit about going forward? I remember, at your Investor Day, you talked about potentially looking into new verticals beyond the niche industrial and consumer side. Any progress or update on that?

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

Yeah, Cris, and thanks for the question. It continues to be a priority area for us. I think we believe that healthcare is probably a vertical that we would like to pursue. Whether it's kind of the next vertical or not, a little bit of it is fluid because it's around finding the right individual with the right experience and the right domain knowledge and then building out around that. I think if the stars all align and that was somebody who had experience in the healthcare space, that is what we're seeking. But it's a little bit of a longer view, to be honest, because we have to find the right individual, vet that person and make sure that kind of the fit from an investment philosophy, from a cultural standpoint is right.

So it's something we are working hard on. We would hope over the course of – by the end of 2022 that we have somebody landed that can start that effort for us, but that's something that we continue to focus on. In the meantime, we continue to add on the HR side. We're adding on our investment team almost on a kind of annual basis. We're adding a couple few people, we continue to staff up because we are building for what we see in the future as a firm that could be substantially larger than we are today, and adding a vertical becomes sort of part and parcel to that.

Cristopher Kennedy
Analyst, William Blair & Co. LLC

Q

Fantastic. And then just I guess a follow-up. As you go towards $1 billion of EBITDA, does your targets – kind of your target size increase a lot? And just kind of talk about how that changes going forward especially with a lower cost of capital. Thanks a lot, guys.

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

A

Sure, and I think that's a great observation, Cris. I mean, our goal is to own companies that have, going forward have the ability to reach at least $50 million of EBITDA; that's sort of internally where we kind of strive to get to. Some companies, they're going to be able to do it through organic growth. Some companies, they're going to need consolidation opportunities to do it. And frankly, some companies aren't going to be equipped to be able to get there. And I would say look at the most recent divestiture that we made of Liberty Safe is totally in connection with that strategic vision, that we want companies to be bigger.

I mean, Liberty is a great business. It's run by great people. We've had a wonderful relationship with Steve Allred, Justin Buck; I mean, guys that we've worked with literally for over a decade. It is a company that has delivered, over-delivered on the expectations that we had. But the reality is we weren't going to be able to get it to a materially larger size, and that's one of the strategic rationales that we've put in place in our business here, is that we want companies that can get to that $50 million, $100 million, even $150 million EBITDA size over time and managing a larger pool of companies or a larger size of companies, not necessarily just a greater number of companies.

So that's sort of where we're focused on. I would say as we think about new platform opportunities, they generally are going to be larger or they're going to have better growth prospects if they're smaller, organic like a Marucci for example which has outstanding growth prospects, or they have really good consolidation opportunities. I think there's a lot of strategic benefits as you get larger companies in the portfolio. As you know, some of the public company things that we do with respect to stock and compliance, that is a little easier to absorb as a public company.

And we don't just give lip service to the ESG efforts that we're putting in place. These are things that we're going to be forcing down on our subsidiary companies. We're doing that at the holding company right now in a really expanded effort. So as we start to put more and more things in place that are more public company in nature and less kind of smaller private company, it helps if we have larger companies in the stable.

Cristopher Kennedy
Analyst, William Blair & Co. LLC

Q

Great. Thanks a lot, guys.

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

A

Thank you.

Operator: Our next question comes from Derek Hewett of Bank of America. Your line is open, please go ahead.

Derek Hewett
Analyst, BofA Securities, Inc.

Q

Good evening, everyone, and congrats on the record quarter. Now 5.11 and Liberty, they represent about 25% to 30% of either revenue or EBITDA. So given the comment earlier that the business really needs to scale, how do you balance opportunities to potentially harvest subsidiaries at attractive valuations versus maybe generating more predictable growth in some sort of adjusted earnings calculation which could also impact valuation, assuming that the C-corp conversion goes forward?

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

A

Yeah, and thanks, Derek, this is Elias, for the nice comments. It was a record quarter and we're really proud of our team, that the subsidiaries were, in the beginning, able to execute at such a high level and against the backdrop of so much uncertainty. But, look, it's a great question. I mean, our business model is frankly different than most companies out there because a portion of what we do is opportunistically divest, and I think that's really what makes us different and creates more opportunities for shareholder value creation.

But sometimes, when you are in divestment windows and the market gives you the opportunity, and so we have to kind of read the tea leaves and take what opportunity the market is giving us. And as part of that, there are going to be times when we will be under-earning our balance sheet potential. You saw it in 2019 when we divested Manitoba Harvest and Clean Earth, and we did it at record multiples. There was a period where we were going to have lower EBITDA on an aggregate basis, outright dollar value. We were going to have lower earnings. As you remember, we waive management fees because it's always been our view that if we're going to under-earn for a potential of time, then the manager should also under-earn its potential. So we align with our shareholders and have done that in the past.

But there are times when the best decision that you can make outside of the optics of, well, you're going to have maybe aggregate lower adjusted EPS or aggregate lower EBITDA is to have assessment and you're taking advantage of the market conditions. And I think that we've always run the business with a kind of more intermediate and longer view and not necessarily a short-term view, and we've said let the opportunity that the market is giving us dictate what's the strategy right that is. So yes, it's possible with the Liberty divestment and other strategic alternatives that we're looking at right now that we could have a smaller portfolio and a smaller balance sheet kind of later in this year or into next year for a period of time until we can redeploy that.

But I would point back to look at how much earnings leverage comes from making the right decision, right? When we divested these assets in 2019, forgetting obviously now a pandemic hit, we were looking squarely down at lower earnings and lower aggregate EBITDA in 2020. But then we took proceeds from selling at really great multiples and redeployed that into two great growth businesses, and now 2021 our earnings have exploded higher. And I think if you went back and looked at 2019 compared to where we guided right now, we're talking about 2020 being like 50 or 2021 being like 50% up in CAD over where we were in 2019.

And so if you take a slightly longer kind of viewpoint on what we do and what we think we're kind of tasked to do, then taking advantage of market opportunities even if it's going to shrink the balance sheet in a near term capacity always works out and builds, I think, greater value as evidenced of the kind of results that we're putting up this year.

Derek Hewett
Analyst, BofA Securities, Inc.
Q

Okay. Thank you. And then in terms of your longer-term adjusted EBITDA goal, is that possible with – how many verticals do you think you would need to be able to kind of meet that longer-term goal?

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

Yeah. I mean, to be honest, we think we probably could go with the verticals that we have. I think that it becomes more probable if we can add another vertical. Over time, I think we would like to probably have one or two more. I think there is a limit to how much we would like. And given that we've had two verticals now for, I don't know, a decade or so once we started to verticalize our business, I don't think we're looking to kind of stamp these out like at an accelerated pace. But I think if we could do one more, it makes getting to $1 billion of EBITDA more probable and very achievable.

That being said, I want to let everyone know we still believe with the verticals we're in, there's a broad enough set of targets and we are positioned extremely well both on capital availability, cost of capital and human capital to be able to achieve that $1 billion goal even if we don't add another vertical.

Derek Hewett
Analyst, BofA Securities, Inc.
Q

Okay. Thank you very much.

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

Thank you, Derek.

Operator: Our next question comes from Matt Tjaden of Raymond James. Your line is open, please go ahead.

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

Afternoon, everybody, and appreciate you taking my questions. First one for me, continuing on the tax reclassification. Kind of on a longer-term perspective, how does checking the box change how you think about acquisition candidates, whether that be in terms of deal pricing or target structure? Any thoughts there would be of interest.

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

A

Yeah, Matt. So the checking of the box won't have any impact on the way that we look at acquisitions in terms of how we structure the acquisition. As Ryan has said, kind of it's we have a little bit different flavor of income that flows up to the holding company. And so I think on the acquisition side, it really is going to have no impact whatsoever. Where it really could have impact is on the divestment side where the company then will have an incremental tax. But frankly, that was the incremental tax that our shareholders were going to be able if we have to pay in the prior structure. So if I think about it from a holistic standpoint, there's no incremental tax and there's no kind of view towards a change of strategy in our acquisition or divestment.

If I circle back to Larry's initial question on benefits of the potential tax structure, we do view having our equity being more accessible by a much broader group of investors who frankly have shown interest in the past. But for the fact that investing in a partnership was something that was very difficult for a lot of people, we think additional demand on the shares naturally should and were to all of our shareholders' benefit through higher share prices and then to the company with a lower cost of equity capital. So I guess that could sort of shape a little bit of our acquisition decision-making. But I would say in terms of kind of how we run the business, we don't look at this structure change is impacting at all.

Matthew Tjaden
Analyst, Raymond James & Associates, Inc.

Q

Okay, fair enough. I guess just another quick one for me on Sterno. So I know last quarter, we talked about venues opening again having some sort of benefit to Sterno. With cases back on the rise and the Delta variant, is there any risk of a near term kind of softening at Sterno?

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

A

Yes [indiscernible] (01:01:09). I'd say we haven't gotten quite back even before if you think about June I think was probably our best month since before the pandemic as far as bookings goes on the sort of foodservice side. And again, those levels were still materially off of sort of pre-pandemic levels. But the foodservice side is a real time indicator, and as sort of events shrink and the number of venues that are open shrink, it will have an impact on the foodservice segment. That being said, our consumer side and some of our waxes and our essential oils are a little bit of a natural hedge for that in that when people spend more time at home, they tend to purchase more of those. It doesn't quite make up for the whole impact that you're talking about if we were going back into a lockdown or something like that again, but it is a little bit of a hedge if that makes sense.

Matthew Tjaden
Analyst, Raymond James & Associates, Inc.

Q

That's it for me. Appreciate the time and congrats on a good quarter.

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

A

Thank you.

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

A

Thanks, Matt.

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

A

Thank you.

Operator: There are no further questions on the telephone line, so I'll hand the call back over to Elias Sabo.

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

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 ends our remarks. Thank you, operator.

Operator: This concludes today's call. Thank you for joining. You may now disconnect your lines.