30-Oct-2019

Compass Diversified Holdings, Inc. (CODI)

Q3 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon and welcome to the Compass Diversified Holdings Third Quarter 2019 Conference Call. Today's call is being recorded. All lines have been placed on mute. [Operator Instructions]

At this time, I'd 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 Holdings third quarter 2019 conference call. Representing the company today are Elias Sabo, CODI's CEO; Ryan Faulkingham, CODI's CFO; and Pat Maciariello, COO of Compass Group Management.

Before we begin, I would like to point out that the Q3 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.compassequity.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.

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 the ratio of its estimated cash flow available for distribution and reinvestment to its distribution. This is because certain significant information is not available without unreasonable efforts including, but not limited to, the company's future earnings, current taxes, capital expenditures and the distribution to be paid as approved quarterly by the board of directors. Throughout this call, we will refer to Compass Diversified Holdings 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, 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-Q as filed with the Securities and Exchange Commission for the quarter ended September 30, 2019 as well as other SEC filings.

In particular, the domestic and global economic environment 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.

Throughout this presentation, references to revenue and EBITDA for Velocity, including Ravin, Foam Fabricators and Sterno, including Rimports are pro forma as if these businesses were acquired on January 1, 2018. Please note that in 2018 CODI acquired Foam Fabricators on February 15, Rimports on February 26 and Ravin on September 4 and their pre-acquisition results described herein are not intended to be indicative of their respective results in the future under our ownership and management or as a measure of our past performance.

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

Elias J. Sabo

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

Good afternoon. Thank you all for your time and welcome to our third quarter earnings conference call. I am pleased to report strong third quarter results in which our consolidated subsidiary EBITDA returned to growth, exceeding our expectations. This was led by strong performance in our branded consumer segment with EBITDA growth of approximately 15% over the third quarter of 2018. Notably, our branded consumer segment is ahead of expectations and we expect this segment to continue to outperform for the remainder of 2019.

Within our branded consumer segment, 5.11 continues to perform significantly ahead of our expectations, with revenue and EBITDA growing approximately 18% and 60%, respectively, versus the third quarter of 2018. The strong performance is driven by the rapid growth in the company's consumer lifestyle segment, tapping into the growing demand from 5.11's enthusiastic, highly engaged and well identified core consumer. 5.11's impressive growth follows our restructuring of the business in 2018 and we believe is a direct result of actions taken at the time along with continued investments in people, systems and logistics.

Our branded consumer segment also benefited from improved performance by our Liberty Safe subsidiary. As mentioned on the previous earnings call, Liberty is benefiting from a new relationship with a large domestic farm and fleet retailer. Our management team at Liberty Safe led by Steve Allred is doing an exceptional job, driving significant market share gains and realizing the benefits of operational leverage.

During the third quarter, we embarked on a restructuring of Velocity Outdoor and recorded a $33.4 million non-cash goodwill impairment charge. The hunting and outdoor channel continues to be under significant pressure, leading to reduced financial performance. Despite the challenges in the marketplace, its archery segment continues to perform well, led by Ravin Crossbows, which brought significant innovation to the crossbows market through its extensive IP portfolio.

To lead the turnaround of Velocity Outdoor, we have added Tom McGann as Executive Chairman and Interim Leader. Tom brings a wealth of experience in growing branded consumer businesses and we are delighted to have him leading our efforts at Velocity. In the third quarter, we realized approximately $700,000 of restructuring costs and, as a reminder, we do not add these costs back to our EBITDA or CAD.

Our niche industrial businesses continue to perform in line with expectations. However, EBITDA declined by 4.7% for the quarter from a year-ago period, reflecting a weakening global manufacturing environment, a relocation of a facility at Advanced Circuits and a timing shift in a large promotional order at Sterno. Pat will talk about these developments in his section.

Based on the strength of our branded consumer segment, during the third quarter of 2019, consolidated subsidiary revenue and EBITDA increased by 3.4% and 3%, respectively, on a pro forma basis from the third quarter of 2018. We expect the strong earnings momentum in the third quarter to continue into the fourth quarter and we expect pro forma 2019 full year EBITDA to exceed the year-ago period.

For the three months ended September 30, 2019, CODI generated cash flow available for distribution and reinvestment, which we refer to as CAD, of $30.2 million, representing growth of over 14% compared to the three-month period ending September 30, 2018. The third quarter of 2019 represents our first full quarter without cash flow from Manitoba Harvest and Clean Earth.

For the nine-month period ending September 30, 2019, CODI generated CAD of $74.0 million, representing growth of approximately 5% over the comparable period of 2018. Our year-to-date CAD is significantly ahead of our expectations. However, we have benefited from lower cash taxes and maintenance capital expenditures in the year-to-date period and we expect higher maintenance capital expenditures in the fourth quarter than originally anticipated. Based on our expectations for solid growth in fourth quarter EBITDA and higher maintenance capital expenditure and assuming $1.44 per share annual distribution, we expect an annual CAD payout ratio of 85% to 90%, an improvement from the 85% to 95% payout ratio referred to on our last earnings call.

Turning to our balance sheet, in the third quarter of 2019, we received the second installment payment from the sale of our Manitoba Harvest subsidiary to Tilray. As part of the second installment payment, we received additional shares of Tilray, which we sold during the quarter and have no shares remaining. The sale of the Tilray shares resulted in a $4.9 million loss from disposition, principally as a result of Tilray shares declining in value during the calculation period.

The divestitures of both Manitoba Harvest and Clean Earth have resulted in CODI having the strongest balance sheet in our history, providing a significant availability to pursue accretive platform and add-on acquisitions. We are proud that we have been able to both significantly improve CODI's balance sheet, while at the same time, retaining sufficient earnings power to cover our distribution. Realizing both balance sheet and income statement improvement simultaneously is a tremendous accomplishment and I would like to thank my team for guiding the company for this achievement.

For the third quarter of 2019, we paid a cash distribution of $0.36 per common share, representing a current yield of 7.1%. This brings cumulative distributions paid since CODI's 2006 IPO to $18.60 per share or 124% of the IPO price. We also paid cash distributions today of approximately $0.45 per share on our 7.25 Series A Preferred Shares and approximately $0.49 per share on our 7.875% Series B Preferred Shares. Both distributions cover the period from and including July 30, 2019 up to, but excluding, October 30, 2019.

I will now turn over the call to Pat to highlight our subsidiary performance.

Patrick A. Maciariello

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

Thanks, Elias. I'll begin with our niche industrial businesses. On a pro forma basis, year-to-date 2019 revenue and EBITDA declined by 1.3% and 2.2%, respectively. These results were roughly in line with our expectations. Advanced Circuits financial performance was below our expectations in the third quarter primarily as a result of a longer than expected shutdown of its Phoenix location associated with a planned move of production to a new custom-built facility. While fully operational at the beginning of October, production in this facility, which represents approximately 20% of Advanced Circuits revenue, was halted for almost the entire month of September. The new facility expands ACI's capabilities and provide both greater capacity and increased efficiencies. Our Advanced Circuits team behind the leadership of John Yacoub worked tirelessly to minimize disruption during this transition and we are optimistic this investment will generate strong results.

Foam Fabricators performed in line with our expectations for the third quarter Foam Fabricators is amongst our shortest cycle businesses and weakness in the domestic manufacturing economy is causing modest revenue headwinds. Sterno performed slightly below our expectations for the third quarter primarily due to a shift in a holiday promotional program at a large retail customer; and 2018, shipments for this program [ph] straddled (12:46) the end of the third quarter and the beginning of the fourth quarter; and 2019, none of the related shipments were made in the third quarter of 2019, but instead will be included in the fourth quarter 2019 revenue.

Arnold Magnetics met our expectations in this quarter and continue to both grow its backlog in Aerospace & Defense and initiate new development projects with prospective customers. We anticipate the realignment of focus towards these growing end markets will accelerate Arnold's growth in 2020 and beyond.

Now turning to our branded consumer businesses. On a pro forma basis year-to-date 2019 revenue and EBITDA increased by 1.4% and 1.5%, respectively, meeting our expectations. Ergobaby's results were down slightly compared to 2018, in line with our expectations. Our core Ergobaby branded products performed well in the quarter. However, our Tula branded products performed below expectations. During the quarter, Ergobaby launched its new Embrace carrier and we are pleased with the initial results.

Liberty Safe's revenue and EBITDA for the third quarter of 2019 exceeded our expectations as the company rolled out product to a new, large farm and fleet customer. We expect Liberty's strong third quarter performance to continue into the fourth quarter.

Velocity's results for the third quarter of 2019 were below our expectations. The hunting and outdoor retail landscape continues to be under pressure. Despite the challenges in the marketplace, its archery business exceeded our expectations. As Elias mentioned, during the quarter, we embarked on a restructuring of Velocity, installing Tom McGann as Executive Chairman and Interim Leader. Given the difficult market environment, we expect Velocity's financial performance to be subdued through 2020. As with other restructurings we have executed in the past, however, we are confident that this process will lead to value creation for all stakeholders.

Finally, our 5.11 subsidiary once again exceeded our expectations as we continue to make progress against our strategic roadmap. In the third quarter of 2019, 5.11 grew net sales by approximately 18% and EBITDA by 60%, a slight acceleration from the second quarter's growth in revenue and EBITDA of approximately 10% and 43%, respectively.

We have opened nine new retail stores in 2019 and, as a group, the 2019 stores are performing even better than a solid 2018 class. We had 54 retail stores open as of September 30, 2019 and expect approximately 60 retail stores by year-end. In addition, 5.11 continues to benefit from investments made in e-commerce and we look to continue to accelerate its growth in that channel. Product innovation remains at the forefront of 5.11 and, in the quarter, the recently introduced Icon pant and Norris sneaker made their way to the company's top seller list. We continue to be pleased with the performance of 5.11 and maintain our view that this business will be our fastest growing subsidiary over the long term and has transformational potential to the entire CODI business.

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

[07D9HK-E Ryan Faulkingham]

Thank you, Pat. Before I discuss our consolidated financial results for the third quarter, I want to highlight the great strides we have made during the first nine months of 2019, strengthening our balance sheet, enhancing our liquidity and positioning the business with strong cash flow generation, which we believe will allow us to cover our distribution on an annual basis moving forward.

As mentioned on our last call, we executed two highly successful divestitures during 2019, generating gains in excess of $300 million, bringing our total gains realized since our IPO to over $1 billion. During the first nine months of 2019, we repaid the remaining balance on our revolving credit facility and paid down our term loan by $193.8 million. We have almost full availability on our $600 million revolver at September 30, 2019.

Our cash balance at September 30, 2019 was approximately $286 million. Taking into account all cash held at CODI on our balance sheet, our consolidated leverage ratio was 1.9 times at September 30, 2019. As a reminder, under the terms of our credit agreement, we have the ability to upsize the available capital on our revolver by $250 million, from the $600 million that it is today to $850 million when we find strong acquisition opportunities in the future.

Finally, the remaining eight businesses are producing cash flow that we believe will allow us to exceed our distribution for the remainder of 2019 and on an annualized basis. On our last earnings call, we estimated our payout ratio would be between 85% and 95% for the full year 2019. As a result of the outperformance in the third quarter and the expected strong performance in the fourth quarter, we believe our payout ratio will improve and be between 85% and 90% for the full year 2019.

Moving to our consolidated financial results for the quarter ended September 30, 2019, I will limit my comments largely to the overall results for our company since the individual subsidiary results are detailed in our Form 10-Q that was filed with the SEC earlier today. On a consolidated basis, revenue for the quarter ended September 30, 2019 was $388.3 million, up 7.8% compared to $360.3 million for the prior-year period. This year-over-year increase reflects strong revenue growth at our branded consumer subsidiaries, notably 5.11 and Liberty, offset by declines in our niche industrial subsidiaries, as previously discussed.

Consolidated net loss for the quarter ended September 30, 2019 was $26.5 million, which included the $33.4 million non-cash impairment charge at Velocity and the $4.9 million loss on the sale of Tilray shares. As Elias mentioned, we sold all of our Tilray shares. Consolidated net income for the prior-year quarter was $5.8 million.

CAD for the quarter ended September 30, 2019 was $30.2 million, up 14.3% from $26.4 million in the prior-year period. The increase in CAD during the quarter was primarily the result of 5:11 Tactical's improved operating performance, lower maintenance capital expenditures of our existing businesses, offset by the loss of cash flow from our two divestitures in the first half of 2019. A highlight of our quarterly performance was our ability to generate an increase in consolidated cash flow from our existing businesses as compared to the prior year, notwithstanding the loss of cash flow from Manitoba Harvest and Clean Earth.

Turning now to capital expenditures. During the third quarter of 2019, we incurred $3.3 million of maintenance capital expenditures compared to $7.6 million in the prior-year period. The decrease in maintenance CapEx was primarily related to the sale of Clean Earth as well as lower spend at Sterno and Advanced Circuits. As Elias mentioned previously, the maintenance CapEx in the third quarter of 2019 was lower than we had expected due to a shift of certain CapEx projects into the fourth quarter and, therefore, we anticipate our fourth quarter maintenance CapEx will be slightly higher than we had originally anticipated.

For the fourth quarter of 2019, we expect to incur maintenance CapEx of between $5 million and $10 million. During the third quarter of 2019, we continued to invest growth capital spending $4.3 million primarily at our 5.11 business. We expect our growth CapEx spend in the fourth quarter of 2019 to be between $5 million and $10 million primarily related to ACI's new facility move and to support 5.11's long-term growth objectives.

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. We are proud of our accomplishments thus far in 2019, executing two highly profitable divestitures of Clean Earth and Manitoba Harvest, generating over $300 million in gains for our shareholders in 2019 and increasing total gains to over $1 billion since our IPO. At the same time, we return to consolidated growth in the third quarter with our CAD increasing double-digit from the year-ago period. Based on the strength of our year-to-date results, we expect an improved annual CAD payout ratio and for full year 2019 subsidiary pro forma EBITDA to exceed 2018. Our efforts in 2019 have resulted in CODI having the strongest balance sheet in its history with unprecedented liquidity to pursue acquisitions.

I would like to close by briefly discussing M&A activity and our forward growth strategy. Middle market M&A activity remains at historically high levels. Debt capital remains robust with favourable terms and strategic and private equity acquirers continue to seek opportunities to deploy available capital. As a result, valuation multiples remain robust. Our acquisition efforts will continue to focus on accretive add-on opportunities and selective platform acquisitions of niche market leaders at valuations where we can expect to exceed our weighted average cost of capital.

Going forward, we will maintain an intense focus on executing our proven and disciplined acquisition strategy, improving the operating performance of our companies, opportunistically divesting when appropriate, distributing sizable distributions and creating long-term shareholder value.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. At this time, your first question comes from the line of Dave King with ROTH Capital Partners.

Q

Hey guys. This is actually [ph] Andrew (22:40) stepping on for Dave. Thank you for taking our questions. So, I guess, just first on 5.11, could you maybe talk about how much growth is driven by the DTC versus wholesale channels? And then within DTC, can you discuss online versus in-store performance.

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

A

Yeah. So, most of the growth of the business is coming from the consumer side. The wholesale side is a very stable, but low growth segment of the business. So you can assume the vast majority of the growth that we posted not only in 2019, but in the third quarter is coming from the consumer side. We don't break out the growth between our retail and e-commerce, but what I would say is our retail comps are positive, they were strong in the third quarter and our e-commerce growth is kind of growing very rapidly as the entire business and brand becomes more mainstream.

Q

Great. That's really helpful. And then also on 5.11, could you just mainly talk about some of the drivers for margin improvement in the quarter? And what do you guys see as the long-term EBITDA margins for the business? Where do you think those could shake out?

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

A

Sure. I mean, on margin improvements, obviously, within the gross profit line was the main driver there, as we do continue to invest in SG&A. The main drivers is sourcing product more effectively and fewer discounts. I mean, without getting into too much detail, those are the drivers. As regards to long-term margins, I'll let Elias comment – and this is Pat, but I'd just say higher. We do think that this can be – continue to increase margins. I don't believe we put a specific number on it.

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

A

Yeah. Part of the margin improvement also is the mix shift. The consumer side of the business has better gross margins and that's leveraging through to better EBITDA margins and dropping through. So, as that mix shift continues, we would expect to continue to see margin – this being margin accretive. Long term I think this is a business that we think is a mid to high-teens type EBITDA margin business. Now, that's long term. In the near term, we view significant investments that we'd like to invest in this business to continue to drive the type of growth that we have. So there's marketing and sales initiatives that we have that we think may temporarily not have margins increase on a linear path like you would potentially expect to get to those levels that I said earlier because you're investing a little bit more heavily upfront in some of those. We're making some technology investments that further enable kind of the omni-channel strategy the company is pursuing. So those investments will temporarily keep the margins from growing at the level that we think they'll ultimately achieve, but this is a business that has significant margin upside as we kind of leverage the system.

Q

That's great color. Thank you for that. And then just switching gears a little bit on Liberty and Velocity, where do you think the gun and ammo cycle is and are you seeing any signs of optimism out there as we approach 2020?

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

A

Yeah. I'd say – so really it's sort of different between the two, although they're both selling to a similar end customer, I think Liberty has done a remarkable job at being able to take market share and probably is masking some of the underlying weakness in just the hunting and outdoor space generally. It's tough to say where we are. I mean, I think we're well below mid-cycle and if you looked over time kind of we had a huge run-up and then the bottom fell out post 2016 and we've been continuing to try to search for a bottom. I'd say there are large national retailers that are changing their view on distribution of certain products and so that's going to impact just foot traffic overall and a lot of the changes and challenges that we are embracing at Velocity, for example, is how we connect to our customer, given distribution which is being altered really kind of as we speak.

So I would say it's our view that we're closer to the bottom. I don't know that we have completely reached bottom and we're not yet seeing the 2020 election cycle result in any type of temporary uptick or even permanent uptick in the underlying activity.

Q

Great. That's helpful. Thanks. And then just lastly for me and then I'll step back. What are your thoughts on divestitures through asset sales or IPOs currently and what are your thoughts on some of the deal multiples that are currently out there?

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

A

Yeah. I would say, as we said on our last call, we expect to be net sort of more neutral right now. Now that doesn't mean in terms of assets acquisitions versus divesture, it doesn't mean that we may not put an asset on our books or sell one from a timing basis, but just generally we expect to be more in a neutral phase and not net divestures at this point. I would say, all that said, all of the portfolio is available for sale at the right price, right. I mean, that's kind of the nature of what we do. And so multiples are elevated in today's environment and we're constantly, as we feel interest in any one of our companies, evaluating whether it's better to hold for our shareholders or whether it's better to divest. In terms of what we're seeing in multiples, I would say for good high-quality companies, it's a double-digit EBITDA multiple environment that we're operating in right now. And I would say that's for general GDP or GDP plus like growth businesses, but that have true barriers and are competitively well-positioned, we see kind of 10, 12 times as the multiple environment that's kind of prevailing out there.

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

A

Yeah. I would say...

Q

That's helpful.

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

A

...if anything on the multiple environment I think it's not slowing down. And what the headline numbers look similar to a year ago or two years ago on sort of multiples in the middle market, but we're seeing and we've seen studies done actually as well is sort of some of the add-backs people are looking to get credit for increasing. So, the like-for-like multiple, if you will, continues to increase.

Q

That's helpful. Thank you, guys, for taking my questions. Thank you.

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

A

Thank you.

Operator: Your next question comes from the line of Larry Solow with CJS Securities.

Lee Jagoda
Analyst, CJS Securities, Inc.

Q

Hi. Good afternoon. It's actually Lee Jagoda for Larry.

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

A

Good afternoon.

Lee Jagoda
Analyst, CJS Securities, Inc.

Q

So, just starting with the Sterno piece, can you talk a little bit about or try to quantify the shift you saw from Q3 to Q4? And then maybe just touch on the medium-term drivers of that business organically and incorporate Rimports into the discussion?

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

A

Sure. So, first on the shift, I mean, it was in the high-single-digit millions is what I would say, without getting – you don't know size of the program one year versus another, but it was in the sort of high-single-digit millions. And we look to be able to get a good chunk of that back in the fourth quarter, as we discussed. I would say, at Sterno, there's some short-term headwinds in our home business having to do with some of the decorative lighting concepts that we provide, a slight headwind in a small segment of our business that has to do with the wet season and the lower amount of planting and home improvement work that have been done and kind of how that flows through the big box customers. So, we might see a little of that. That's also the lower margin portion of our business. We might see a little of that in Q4 kind of making up for the – or kind of as a headwind to some of that revenue that we're shifting into Q4, if you will.

I'm sorry your other question was on just the long-term drivers of growth or how do we think about growth of the business? Is that correct?

Lee Jagoda
Analyst, CJS Securities, Inc.

Q

Yes.

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

A

Yeah. I don't think this is – this is not 5.11. You have to kind of separate the business really into a couple parts. I think the Sterno product side, which is the diethylene glycol and the gel fuels is sort of GDP, GDP plus business that's incredibly well-run and efficiently run.

I think on the sort of Rimports side, if you look into the wax, the wax cubes, we continue to come up with innovative products there and I would hope that we can grow that business a little bit faster than the core. And then similarly on the home business, which is candles, decorative lighting, I see that as kind of more GDP, GDP plus, so I'd say kind of two-thirds of the business are in that sort of GDP range and the hopes is that the Rimports business, the wax, warmers, essential oils, et cetera, can help accelerate the combined business a little faster than that and to hopefully mid-single-digits – low to mid-single digits.

Lee Jagoda
Analyst, CJS Securities, Inc.

Q

Great. And then as it relates to your acquisition pipeline, whether it's tuck-ins or new platforms, are there any verticals that we should be thinking about that are particularly attractive to you at this point?

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

A

No. We don't do as much of a top-down analysis thinking are we looking for investments in our niche industrials or in our consumer. A little bit more is kind of what we're out seeking and what we see is available for sale. So there's not a concerted effort in one or the other. That being said, you've seen some of the pressure that we've experienced this year in our industrial segment really is following what we're seeing on a global basis. And all the headline numbers are coming down. I think we're performing really well, frankly, especially considering the disruption in earnings from the Advanced Circuits move and the timing shifts that Pat just said at Sterno, especially concerning those two things, we feel really good about how we're doing versus the overall environment that we are operating in. But I would say that for industrial businesses today, especially for new platforms, the valuation multiples are really high. And if we think that the environment is potentially reduced and, I guess, a lot will depend on what happens with kind of the trade war and some other global kind of headline risks that are out there, I'd say, right now, though, it feels like prices remain elevated without having a good supportive environment underneath it to be able to invest again.

So there's a slightly higher bar on industrials today that could turn around if the manufacturing environment starts to look a little bit more promising, but we're looking aggressively both in the industrials and consumer space. I would say, most of our efforts continue to be on add-ons as we think we have eight really strong companies, most of which we'd like to deploy significant capital to grow to be much larger than they are today.

Lee Jagoda
Analyst, CJS Securities, Inc.

Q

That's very helpful. Thanks very much. I'll hop back in queue.

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

A

Thank you.

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

Kyle Joseph
Analyst, Jefferies LLC

Q

Hey, afternoon, guys, and thanks for taking my questions.

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

A

Good afternoon, Kyle.

Kyle Joseph
Analyst, Jefferies LLC

Q

So, Elias, you've spoken a lot about the deal environment and combine that with the fact that your balance sheet is in the best position to-date. Can you just remind us of your capital allocation priorities given the deal environment? I saw guys paid down some of the term debt in July, but noticed that your cash balance is still very high compared to where it has been historically. So if you can just refresh us on your capital allocation priorities given the strength of your balance sheet?

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

A

Sure. Let me just first start out by saying what we view as most important to our business is payment of the distributions on our common and preferred stock. And we paid it for 13 straight years, more than that now since coming public and as you know, Kyle, even through the financial crisis, we never had to cut. So we're extraordinarily proud of that and believe it's something that investors have come to really expect of us. So, that is very much in our minds when we think about capital allocation just broadly.

I would say, in general, where we stand today is it's not lost on us that we're 11 years into an economic cycle and that it's the longest in the history of the US and these things typically don't go on forever and there are some elevated risk and pricing on the other hand remains extraordinarily high. So we've tried to be disciplined, which I think we've done a really good job over the years being, and position ourselves defensively right now. And so that does mean we have more cash. We have more availability than we have had a historical period. But I think it's important in order to have that because at some point, and I can't tell you whether that's three months or three years, but at some point there likely will be a good buying opportunity and a lot many times it's a result of credit markets that end up freezing and having more availability in those times is in the long term the best thing that we can do to create shareholder value.

So, for right now, our capital – we are keeping more cash, it is there for acquisitions. Now we are aggressively chasing out on. And I think we will find some opportunities to put money to work through our companies where we can get better purchase price multiples and where we can create some strategic value. But I think just, in general, our philosophy where we sit right now in the cycle is to maintain higher amounts of liquidity than normal and hence a more defensive posture.

Kyle Joseph
Analyst, Jefferies LLC
Q

That makes perfect sense. Thank you. And just given another rate cut today, can you remind us how CODI and, I guess, we almost have to think about it on a company-by-company basis, but how CODI does in kind of a lower rate environment, given the forward curve right now?

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

Yeah, sure. Kyle, so the floating rate today from our capital stack standpoint, we have a floating rate on the revolver, of course, we've got nothing outstanding there. The Term Loan B floats. So that in effect will benefit us a little bit on the Term Loan B. Offsetting that, though, is a swap on a portion of that outstanding Term Loan B that would go the other way. So kind of net a little bit of a benefit on the Term Loan B. Of course, our bonds, which are fixed, but yet I think the lower rates, of course, help where those trade today, I think they're close to [ph] $106 or $107 (38:50) so those are trading well. But I think, of course, too, the lower rates make our preferred and our common more attractive. I think we're seeing that in the marketplaces are as our share price rises.

From a subsidiary standpoint, that debt with them, some of that is fixed, some of that floats. So, to the extent there's lower interest rates, there's technically slightly lower less interest to us. However, recall that we own all their debt and they want to pay off their debt as quickly as possible. So any interest savings effectively comes up via principal payment. So that really won't be impacted much. So I would say looking across our capital stack, net-net, not a significant impact.

Kyle Joseph
Analyst, Jefferies LLC
Q

Got it. Thanks very much for answering my questions and congratulations on a good quarter.

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

Thank you, Kyle.

Operator: [Operator Instructions] And your next question comes from the line of Robert Dodd with Raymond James.

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

Hi, guys. Looking at Velocity, obviously, I mean, you talked a little bit about the restructuring and new management essentially there, but can you give us some color on what are the expectations? Because if I look at revenue this quarter, I mean, first half revenue was up 1%, that's with Ravin this year, without Ravin last year – without last year. So, it's negative organic growth. But this quarter $46 million, up a bunch. So far as I know that's an all-time high EBITDA as well. So has there has been something very recent has changed, so can you give us some color on what the real expectations are from you for this business that's necessitating the charge and the new approach?

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

A

Yeah. So, Robert, on an organic basis, the business has been down pretty substantially in the first half of the year 2019 compared to 2018 and that is when you have the pro forma effect of adding in the Ravin acquisition, which we did in late 2018. So, on a kind of like-for-like organic basis, the business ran down pretty significantly in the first half of the year. I'd say a lot of that is due to market conditions. I think the products still are good products, our archery business is doing extremely well. The third quarter was a significant improvement and part of this is due also to some headwinds that we talked a lot about with respect to a JROTC contract that got [ph] build (41:50) in 2018, but wasn't even open for 2019 and Ravin was, because it's a relatively new technology in the market, had a bunch of stocking orders in 2018. So there were also some market factors that caused the comparables in 2018 to be difficult for 2019.

All that being said, when we looked at the business and its positioning and sort of kind of how we felt it was operating, we thought that, one, the channels of distribution were changing really dramatically and that we needed to come up with a different approach to be able to connect to our customers and to adapt to the changing world. And we brought Tom McGann. As CEO, Tom has run a number of consumer product businesses and has some really great ideas about – and has executed this in the past about how to effectively reach customers in a kind of changing distribution format. And so, as much as anything, we felt that we needed sort of a new directional change to cope with where the retail environment and where the distribution is moving to and we're really fortunate to get a guy that we've known for a number of years, became available, is very seasoned and bringing him in I think like we've done in other businesses will mark a change in trajectory.

Now, all that being said, as you know, when we go through and we restructure our business, it typically takes a little bit of time before some of the new programs are able to get traction and you start seeing growth. So I would say we have maybe a little bit higher expectations than what we said, but I would say for everybody right now we think that financial performance it's probably near the bottom right now. There may be a little bit of downside, not a lot probably from this level, but I think over the course of the next year we're going to be doing some new things, there'll be some costs that we need to incur in order to rethink our distribution and connectivity to our customers that will drive long-term value. So I don't think this is not a V-shaped recovery by any means, but I think it's one where we would hope to kind of bottom out around the levels that we're at now and then as we progress forward when some of these new initiatives take hold, we think the company can resume back to growth probably 2021 and beyond.

And the impairment is really just a function of the accounting folks make us put together what they think the cash flows are, it's really representative a lot of the historical performance and because the company performed below our expectations, it goes through kind of a step one and step two impairment analysis and then model produced kind of the results that you see the $30 million impairment.

Robert Dodd
Analyst, Raymond James & Associates, Inc.

Q

Understood. On that, I mean, the way you talk there with connect customers and distribution focus, it's somewhat similar to the choices of words [ph] and things (45:17) you were using it I would say three years ago for 5.11, right, in terms of more online, more direct-to-consumer, more opening the store. So, is the goal here to take Velocity from the distributive relationship to more direct-to-consumer product marketing? I mean, it worked for 5:11, but is that the kind of thing you're thinking right now?

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

A

Yeah. So, Robert, I would say we really need to be doing that with all of our companies. And one of the things that's happening, we all hear about and know that Amazon is growing dramatically and the whole online world is growing so dramatically. Historical distribution to be set up to go through – solely through big box mass merchants, it's just changing dramatically. And so, all of our companies need to think about connectivity to customers, creating communities where customers can interact with our products and the lifestyle that our products afford to them and very much in the way that we talked to you about this with 5.11, 5.11 is a little bit different because it's got such a broad line and has the ability to open retail boxes, probably not the same, if you thought about a Velocity or an Ergobaby or a Liberty, they don't have maybe the same breath of opportunity that 5.11 has there. Well, all of our companies are moving in a manner to create more connectivity to their customers, to be able to provide them with product, if distribution isn't available locally to them. And so everybody needs to go through that change and I would say that's what we are embarking on with Velocity.

The channel that Velocity went through has been very much disrupted, but it had been a really stayed and stoic channel for many, many years. And so, we needed to get that process rolling and thinking about distribution and consumer touch points different than how they had done that. And that's why we're – we're, frankly, notwithstanding the fact that the financial performance has been weak this year and we had to go through a restructuring. We believe this is a lot of the value that we add, right. I mean we're active managers here to these companies. And when we bring in someone at the skill level of a Tom McGann, this is when we think the inflection point for value starting to increase starts again. So, we're pretty excited about what this will portend for the future for Velocity.

Robert Dodd
Analyst, Raymond James & Associates, Inc.

Q

Got it. I really appreciate that color. And you dropped the name in there as well that I was going to ask about next, obviously, Ergobaby, right. Same kind of issues disrupted the distribution with Babies "R" Us, et cetera, et cetera. So, is there anything new – they've been through some new product development cycle [ph] I'm talking of (48:22) several years and the management has had just some tweaks throughout that process as well. Anything that can be done incrementally over and above what you're doing right now? Because obviously, I mean, we're looking probably at a down revenue year again this year. That'd be three years since we've seen any revenue growth. Yes, the channel difficulties are there. But is there anything that can be done in the manner that maybe you are approaching Velocity that can kick-start that business and maybe get to a breakthrough to back to revenue growth?

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

A

Yeah. So, first, I would say, it's kind of two different – there's two different business segments there that I'm going to point to. And we touched on it a little bit in the transcript, but the Tula business, which we acquired at a pretty modest multiple of EBITDA when we acquired it, has faced significant headwinds and is driving a lot of that, if not all of that decline. The Ergobaby business is solid and actually I think it had a little bit revenue growth this quarter and is kind of more solid and on a better trajectory. We do think Tula is stabilizing and they have some great new products and some great new marketing initiatives.

The Ergobaby business is really an international business too, which helps – where the majority of its revenue is generated outside of the US and those markets are all doing fine. The things you talked about on Babies "R" Us and kind of a general headwind [ph] the juvenile (50:04) in the US birth rates are down. We need to continue to come up with new products to excite the consumers. I think we did that with the Embrace. I think we did that with our Metro Stroller and some of these products will catch fire like our hope is and our belief is like the [ph] 360 did and like (50:20) we've had products do it in the past. So really at Ergobaby I think the company is connected to its customer. I think the company has been able to really generate strong relationships with mothers, but I think there it's more about innovation, product design, et cetera.

Robert Dodd
Analyst, Raymond James & Associates, Inc.

Q

Okay. Got it. I appreciate it. Thank you.

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

A

Thank you, Robert.

Operator: Your next question comes from the line of Brian Hogan with William Blair.

Brian Hogan
Analyst, William Blair & Co. LLC

Q

Yeah. Good afternoon.

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

A

Good afternoon, Brian.

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

A

Hey Brian.

Brian Hogan
Analyst, William Blair & Co. LLC

Q

My question is actually 5.11. [ph] Nice (51:00) started off this year and you said the store has been performing above your expectations and, I guess, one of my questions is how many stores ultimately do you think you can have and how long [ph] does it take (51:12) to get there? And then what have you done to change your site selection given the strong performance in 2019?

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

A

Yeah. I'll start with kind of what we think the potential is. Our potential we think, Brian, is probably 250 to 300 stores right now, but that's fluid, to be honest with you, and as stores either perform a little bit better, it goes into a model that is quite dynamic and that could increase to 400 or 500 depending on performance, maybe some marketing initiatives locally and just as the brand becomes more aware, the market opportunity will grow. But as we stand today with the brand where it stands today, which still is relatively in its infancy from a consumer lifestyle brand, we think that it's sort of a 250 to 300 potential store against kind of 60, which we'll have at the end of the year. I'll let Pat touch on your second part of your question.

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

A

I think we – Matt Hyde is a very senior executive at REI, ran West Marine. I think he's added another sort of layer of statistics on to sort of some of the stories we're looking at and where the right sites are. Company did a good job before I think that's even improved. I think broadly we're probably, based on those statistics, it doesn't need to be in a 5 million person metro complex if the stats speak to the strength of a market, right, in El Paso or a smaller city, we've been probably more open to and I think those things have driven results.

Brian Hogan
Analyst, William Blair & Co. LLC

Q

Right. And going back on the store growth, I mean, do you think you can do 20 a year or what's...?

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

A

Yeah. I would say 20 seems like a good target for right now and a little bit – as the company continues to grow, we can add more resources and so I think it may accelerate over the next couple of years, Brian. But for right now, I think 20 to 25 is probably a reasonable target. In 2019, it's going to be a lower store opening. But part of that was because with the new management team that we brought in, as Pat said, we also brought in some expertise in retail location and identifying what are the proper market conditions that we should be using to figure out where our next store is going to go.

And Pat mentioned this on the script, but our 2019 class is performing much stronger than our 2018 or 2017 classes and those were both pretty good classes. So, the new model is working really well. We felt it was important to slow down growth in our retail footprint temporarily, which is why we had very little activity in the first six months of the year until we got our model built out and knew exactly kind of what the right locations were going to be. And now I think we're back on pace in terms of the roll out of our retail at kind of a couple of months.

Brian Hogan
Analyst, William Blair & Co. LLC

Q

Sure. And then last question just on 5.11. In my estimates, inventory turns at 5.11 are pretty low relatively speaking to its peers. And obviously, you have uniforms and I get that. But is there opportunity to improve that and drive significant amount of opportunities [ph] into (55:07) cash.

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

A

Yeah. As we move to more of a DTC customer, the law enforcement customers require us to carry a full array and a full assortment in every imaginable size, right, as you're fitting out a police force or an EMS force. As we move to a more consumer, I'd say two things. First, we've made some hires and promoted some people who are very capable and are taking a harder look at inventory every day, and that's starting to pay off. Second, I would say, as we move to more consumer, we should be able to get better turns as well as these – the sort of balance of the business. The consumer business, the wholesale, the DTC turns faster than the law enforcement side.

Brian Hogan
Analyst, William Blair & Co. LLC

Q

Sure. All right. Thank you for your time.

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

A

Thank you.

Operator: And at this time, we have no further questions. I would now like to turn the call back to Mr. Elias Sabo.

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

I would 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.

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

Thank you.

Operator: Thank you for joining Compass Diversified Holdings third quarter conference call. Have a wonderful day. And you may all disconnect.