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Compass Diversified Holdings, Inc. (CODI)

Q1 2022 Earnings Call

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Analyst, William Blair & Co. LLC

Robert Dodd
Analyst, Raymond James & Associates, Inc.

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MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, and welcome to Compass Diversified's First Quarter 2022 Conference Call. Today's call is being recorded. All lines have been placed on mute. [Operator Instructions]

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

Cody Slach
Senior Managing Director, Gateway Investor Relations, Inc.

Thank you, and welcome to Compass Diversified's first quarter 2022 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 Q1 2022 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 closed, which includes reconciliations of non-GAAP financial measures discussed on this call, including adjusted EBITDA and cash available for distribution, and is also available at the Investor Relations section of the company's website.

Please note that references to EBITDA and the following discussions refer to adjusted EBITDA as reconciled to net income or loss from continuing operations in the company's financial filings. The company does not provide a reconciliation of its full-year expected 2022 adjusted earnings or adjusted EBITDA because certain significant reconciling information is not available without unreasonable efforts. Throughout this call, we will refer to Compass Diversified as CODI or the company.

Now allow me to read the following Safe Harbor statement. During this conference call, we may make certain forward-looking statements, including statements with regard to the future performance of CODI and its subsidiaries, and statements related to the impact of CODI's updated tax structure and the impact and expected timing of acquisitions and dispositions. Words such as believes, expects, plans, projects and future or similar expressions are intended to identify forward-looking statements. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors could cause actual results to differ on a material basis from those projected in these forward-looking statements and some of these factors are enumerated in the risk factor discussion in the Form 10-Q as filed with the SEC for the quarter ended March 31, 2022, as well as in other SEC filings.

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

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

Elias J. Sabo

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

Good afternoon, everyone, and thanks for joining us today on our first quarter 2022 conference call. I'm pleased to report that we carried last year's momentum into the first quarter of the year where we recorded our fifth consecutive quarter of record results that is enabling us to raise our 2022 outlook. We're extremely pleased with these results, and I want to acknowledge and thank our management teams and employees. They continue to put forth an extraordinary effort that we believe will generate sustainable long-term value for our shareholders.

In our last earnings call, we discussed our strong execution against a tough macro environment and this quarter was certainly no different. Supply chain constraints, inflationary pressures, and the lack of labor were all rising headwinds our companies had to navigate in the quarter. Our ability to execute on our strategy despite these constraints is a testament to the strength of our management teams and the quality of the companies we own.

During the quarter, we delivered double-digit sales growth in both our branded consumer and niche industrial businesses. Importantly, our fastest growing business, BOA Technologies, continued to perform above expectations as revenue and adjusted EBITDA growth continued to accelerate. In fact, BOA's $25 million of adjusted EBITDA in the first quarter represents the highest EBITDA producing quarter our CODI's business has ever reported. As we have said on prior calls, BOA's unique combination of disruptive technology, strong intellectual property, relatively low penetration and very large addressable market when combined with an extraordinary management team, has led to performance that is significantly stronger than expected when we acquired the business a year-and-a-half ago.

One component of the growth story to keep in mind for the first quarter, however, is the elongation of the supply chain. So, it's conceivable some of this quarter's demand reflects pull forward from future quarters, but with only 5% penetration in the addressable market, we remain quite optimistic that BOA's long-term growth story remains intact.

Lugano continues to perform significantly ahead of our expectations. And as mentioned on our Q4 call, we have seen a historical relationship between inventory investment and highly profitable revenue growth, paid dividends. We were excited our investment translated into almost 50% pro forma adjusted EBITDA growth and we will plan on putting more capital in this business as this correlation is expected to continue.

Overall, we did an extraordinary job posting year-over-year growth while preserving margins. In the first quarter, we had only a 100 basis points of margin degradation, despite unprecedented supply chain and inflationary conditions. Though we anticipate the economic headwinds that impacted our margins could persist in the short term, we believe that the quality of all our subsidiaries' competitive positioning allows us in a more stable inflationary environment to be able to fully recoup all of that margin.

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

Patrick A. Maciariello

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

Thanks, Elias. On a combined basis, revenue and EBITDA in both our branded consumer and our niche industrial businesses grew meaningfully and exceeded our expectations. As Elias mentioned, our businesses performed admirably throughout the continued supply chain and inflation headwinds, though these headwinds led margins and EBITDA performance to lag revenue growth slightly. While we are working through appropriate cost and pricing actions at each business to address the modest margin compression, these actions often take time to implement and may not be reflected in our financial performance in the short term. Our management team partners at each of our businesses continue to execute for their customers and employees, and I remain very proud to work with each of them.

Now to our subsidiary results. I'll begin with our niche industrial businesses. For the first quarter of 2022, revenues increased by 19.5% and adjusted EBITDA by 9.4% versus the first quarter of 2021.

Arnold and Altor both posted meaningful revenue and adjusted EBITDA growth in the quarter, driven by solid execution and stronger-than-expected demand. Altor's margins declined somewhat due to higher raw material costs. We expect that most of these costs will be passed through contractually later this year.

At Sterno, demand for our catering products grew significantly throughout the quarter and into Q2 as leisure travel and conventions continued to return domestically. Sterno's scented wax products, however, saw a reduction in demand from an abnormally strong first quarter of 2021, which is likely partially driven by federal stimulus payments in that period.

Turning to our consumer businesses. For the first quarter of 2022, revenues increased by 14% and adjusted EBITDA increased by 13% compared to Q1 2021. Demand for BOA's Performance Fit business and continued to exceed our expectations. The company's revenue increased by over 55% in the quarter and it delivered a CODI record $25 million of quarterly EBITDA. Similarly, Lugano grew pro forma adjusted EBITDA by over 46%. As stated, we are seeing a direct correlation at Lugano between inventory purchases and revenue. We believe the team at Lugano has created a better business model to serve the needs of their clients. We will continue to support Lugano as they grow and open new salons in the back half of the year, which will continue to require intelligent investments and relatively liquid inventory.

Also in the quarter, Marucci made a series of strategic decisions to airfreight in significant product to retail partners to gain shelf space in both new and existing product categories. This led to strong revenue growth, though impacted margins in Q1. We believe this decision will have significant long-term benefits for the company.

Marucci will have a tough comparison in the second quarter as the company has several products in Q2 2021. We are excited and optimistic, however, about the much anticipated launch of the [ph] CapEx (09:58) in the third quarter and believe it should lead to favorable comparisons in that period.

Turning to Velocity, as anticipated, we experienced a return to pre-pandemic demand levels in the company's air gun business in Q1. We believe we will have another difficult comparison in the second quarter of this year as the company continue to replenish retail inventory levels in Q2 of 2021, but we'll be comparing to post-pandemic demand patterns in the back half of 2022. As a whole, we are pleased with the performance of our businesses in the first quarter and remain optimistic about the remainder of the year.

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

Thank you, Pat. Before I get into our financial performance, I wanted to make a few comments regarding Advanced Circuits. Last quarter, we indicated that the closing of the ACI sale remained on track and was expected to occur early in the second quarter. For the terms of the merger agreement, the merger of ACI and Tempo is subject to and conditioned upon a concurrent business combination between Tempo and ACE Convergence Acquisition Corp., which is a SPAC. Earlier this week, ACE announced that the previously scheduled shareholder meeting to approve the Tempo-ACE business combination has been postponed to allow ACE additional time to revise and finalize its financing arrangements. As a result of the announcement, we will not be taking any further questions related to the ACI transaction.

Moving to our consolidated financial results for the quarter ended March 31, 2022, I'll 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 March 31, 2022 was $510.5 million, up 25% compared to $408.6 million for the prior year period. This year-over-year increase primarily reflects the company's acquisition of Lugano in September of 2021, as well as a strong double-digit growth from BOA, Marucci Sports and Altor Solutions.

Consolidated net income for the quarter ended March 31, 2022 was $29.7 million, a 35% increase compared to $22 million in the prior year ago quarter. As introduced last quarter, adjusted earnings, a non-GAAP financial metric, will allow investors to assess our operating performance in a more meaningful and transparent way. Adjusted earnings for the quarter ended March 31, 2022 was $36 million, up $9.9 million or 38%, from the year ago quarter. Our adjusted earnings generated during the quarter were above our expectations, primarily due to the strong performance across our consumer and industrial businesses on a combined basis.

Turning to our balance sheet, as of March 31, 2022, we had approximately $97.3 million in cash, zero drawn down on our revolver, and our leverage was approximately 3 times. We have substantial liquidity and as previously communicated, we have the ability to upsize our revolver capacity by an additional $250 million. With this liquidity and capital, we continue to be well-positioned to provide our subsidiaries with the financial support they need, invest in subsidiary growth opportunities, and act on compelling acquisition opportunities as they present themselves.

Turning now to cash flow. During the first quarter of 2022, we used $33.5 million of cash flow from operations, primarily a result of our strategic investment inventory at Lugano. In addition, certain of our subsidiaries saw an increase in inventory in transit as a result of the port and trucking delays. As we've mentioned before, we believe a significant strategic advantage of our business model is that with our strong balance sheet and access to capital, we can sustainably invest in our subsidiaries for the long-term. And in today's challenging supply chain environment, ensuring our subsidiaries have adequate inventory to meet their demand levels is crucial and accelerating our competitive advantages by solidifying strong customer relationships. It's important to note that when the supply chain challenges abate, the strategic investments we've made in inventory will convert to cash.

And finally, turning to capital expenditures, during the first quarter of 2022, we spent $10.4 million of capital expenditures for our existing businesses compared to $7.3 million in the prior year period. The increase was primarily a result of the continued retail store expansion at our 5.11 subsidiary.

Despite our excellent performance in the first quarter, we remain in uncertain times, driven by market and interest rate volatility, the unexpected GDP contraction that was recently reported, inflationary pressures causing commodity prices to rise and labor market shortages.

However, as a result of our company's strong performance in the first quarter that exceeded our expectations, we are raising our 2022 full year consolidated subsidiary adjusted EBITDA outlook to between $410 million and $430 million, a $10 million increase in the bottom and the top end of the range. Further, we are raising our 2022 full year adjusted earnings outlook to between $120 million and $135 million.

Moving to CapEx, for the full year of 2022, we continue to anticipate total capital expenditure spend of between $70 million and $80 million While this is a large increase from 2021, we believe these investments will have short payback periods and provide strong returns on invested capital. The 2022 capital expenditure spend will primarily be at Lugano for new retail salons and at 5.11 as we continue to increase its retail store count from its current 88 stores.

We believe our companies are positioned extremely well even better than before and have the utmost confidence in our management teams to continue to drive strong results that ultimately create long-term sustainable value for our shareholders.

With that, I'll 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 providing an update on the M&A market, CODI's corporate initiatives and discussing our go-forward growth strategy. Beginning with the overall M&A market, activity remains depressed as potential sellers are choosing to delay processes given the economic headwinds and the macro backdrop. We anticipate activity to remain depressed in the second quarter as these headwinds persist, followed by a gradual uptick in activity in the back half of the year if these headwinds start to moderate.

As a brief update on one of our primary corporate initiatives, we are aggressively enhancing and institutionalizing our ESG practices. As we have stated in the past, we believe sound and well-implemented ESG practices not only can be beneficial to society and our environment, but also contribute to the management of risk and enhance long-term returns. In this regard, I am excited to share our progress today.

By way of background, our ESG strategies will focus on initiatives such as diversity, equity and inclusion of people and thought, health and well-being of our customers and employees, attracting and retaining the best talent, environmental considerations, transparency and continuing to be a trusted partner with investors, businesses and communities. Fundamentally, CODI's ESG strategy is a primary business decision that will be anchored throughout the corporate ethos in order to directly enhance CODI's purpose of building sound and sustainable businesses, culminating in strong shareholder returns. Along these lines, we have begun to directly link and implement our ESG practices into our portfolio companies vertically integrating and aligning these strategies throughout the organization. These ESG parameters will become an important factor in managing risk, reducing the cost of capital and expanding multiples at all of our companies.

Additionally, diversity continues to stay front of mind during our hiring process, and we have recently added three talented diverse hires to our team. We believe diversity of people and thought introduces new perspectives, skills and approaches to problem solving that enhances the company's strategic and operating capabilities. We are pleased with our progress today and feel confident that we can continue to expand on these efforts.

In conclusion, it was a great quarter for CODI. Relative to our expectations, our performance was outstanding. In this backdrop, the fact that gross domestic product contracted 1.4% and we grew revenue and adjusted EBITDA by double-digit is an incredible effort. And I'd like to give thanks and recognition to all of our management teams and employees.

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

QUESTION AND ANSWER SECTION

Operator: Certainly. [Operator Instructions] We have the first question comes from the line of Matt Koranda of ROTH Capital. Your line is now open, you may ask your question.

Matthew Koranda
Analyst, ROTH Capital Partners LLC

Q

Hey, guys. Good afternoon. Nice start in the quarter.

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

A

Thanks, Matt.

Matthew Koranda
Analyst, ROTH Capital Partners LLC

Q

So, just maybe starting out with one thematic and then I'll follow-up with maybe one or two on the segments. But just in terms of the consumer businesses, you guys have a lot of diversity in your consumer segment, if you will. So any takeaways that you guys have on consumer behavior sort of through the arc of the first quarter and maybe through the last month here, just any changes that you've noticed in terms of behavior on the higher to low end as consumers kind of respond to the inflationary environment, the public market volatility or the Ukraine-Russia conflict?

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

A

Yeah. Matt, it's kind of we obviously are monitoring trends throughout our entire portfolio, and even in our industrial business where some of the end products may make its way into kind of the consumer markets. I would say, in general, we were surprised by the strength of consumer spending, pretty much across the board in the first quarter, really with the exception as Pat mentioned, of Sterno, where our scented wax product benefited greatly from some of the pandemic condition, people staying at home and I think that drove a significant increase in demand for that product, and that saw some weakness.

Now, I would also say one conclusion we could draw is that also goes through the mass channel principally. And I think if you thought about kind of consumer stratification, it feels that the kind of more affluent customer right now is continuing to spend. If I was venturing a guess, wage gains are offsetting for that consumer, their basket of goods and how they measure inflation. And yet on the lower end of the spectrum with sort of the more mass products and lower price points, my sense is inflation is eating away at purchasing power and if somebody is making a decision to buy eggs or milk or buy kind of a consumer discretionary product, clearly staples become the thing that they purchase.

So I think, we are starting to see initial signs of erosion for sort of more of the mass consumer and the lower price point items as inflation is quite problematic and eroding purchasing power there. But as you know, most of our consumer businesses are more enthusiast type brands and they tend to skew towards the higher-end consumer, the more affluent consumer, and we just have not seen a real weakening of demand there. And in fact, as we run forward through April, I would say we continue to see really good strong demand across most of the consumer portfolio. So, we have not seen weakening. I think some of the market volatility that we're starting to see right now could eventually play into that. But it has not manifested yet into any of the real-time data that we're seeing.

Matthew Koranda
Analyst, ROTH Capital Partners LLC

Q

Okay. Super, thorough and helpful. Thank you. And then maybe just a segment one, I mean, BOA putting up pretty stunning growth and margins to boot, just was curious if you guys might be able to – I mean, you can't really quantify pull forward there, but I'm wondering how much is your sense that has pulled forward some revenue from, like the footwear OEMs and may be a little bit nervous about supply chain disruption versus sort of just core growth and share take for that business?

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

A

All right. Matt, this is Pat and thanks. It's a good question, and one we spent a lot of time thinking. I can tell you, demand is broad at BOA. It's in many channels and we think it's strong and can see in the second quarter and we think it's sustainable. I could tell you there might be some pull forward if you think about the – what is there on [ph] horizon (24:11), another month, another 45 days, right, that there wasn't sort of a year and a half ago. If you think of that as sort of a small headwind, but we think we're going to perform very well despite that. And we think much of the demand – most of the demand is real.

Matthew Koranda
Analyst, ROTH Capital Partners LLC

Q

Excellent. And then I'll go to sneak one on Marucci as well, I was just curious about in that segment, where do you think you're taking the most share? You mentioned kind of using airfreight strategically to kind of fill customers and then win shelf space, so just curious like in which categories maybe that you think you're winning the most share there? And then did the costs essentially go away in the near-term, or are we going to kind of continue to use that as a tool to continue to take share?

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

A

So answering your second question first, we'll selectively use it as a tool, but they should mitigate. And as we look ahead, a lot more kind of what we have planned in Q3, Q4 sales is not using expedited freight. Going back to your first question, we're trying to grow in a lot of categories. And some of that airfreight that we spent helped us do that this quarter, be that gloves, be that bags, be that fast pitch softball, we think that Marucci is a disruptive brand that really has the potential to expand into additional adjacencies within baseball, within softball and maybe beyond. And so that's the opportunity we took in Q1.

Matthew Koranda
Analyst, ROTH Capital Partners LLC

Q

Okay. Excellent. I'll leave it there guys. Thank you.

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

A

Thank you, Matt.

Operator: Thank you. We have the next question, it comes from the line of Chris Kennedy of William Blair. Your line is now open, you may ask your question.

Cristopher Kennedy
Analyst, William Blair & Co. LLC

Q

Thank you and good afternoon, and thanks for taking the question. Can you give a little bit more details on Lugano just because we don't have the history with the business? Are we kind of at a normalized run rate, or how should we think about that going forward?

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

A

So I mean, I think Q2 or Q1, excuse me, is seasonally a bit high. We have a location in Aspen that is a heavy Q1. All that being said, the business has seen a noticeable uptick in sort of run rate. And so, I would say, can you say you can multiply Q4, no – Q1 by four to get to our current run rate, no. But the business has seen significant, significant growth in underlying demand, and we see that continuing.

Cristopher Kennedy
Analyst, William Blair & Co. LLC

Q

Okay. Great. And then, Elias, I appreciate your comments on potential acquisitions in the space. I assume you're mostly referring to platform deals, but can you talk about add-on opportunities?

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

A

Yeah, sure, Chris. I mean platforms certainly have been slow in the beginning of the year given all the headwinds. And I think a couple of things are clearly occurring there. You've got earnings degradation from – for the vast majority of companies, I mean we were able to buck this trend. But for most companies dealing with supply chain in the inflationary environment is causing their earnings to take a hit.

And generally sellers don't want to be in the market in those conditions and then if you couple that with the multiple compression and just the risk off sentiment that you're seeing in the public markets, that clearly factors its way through the private markets and for kind of the deals that we're looking at that also our competitors would be tapping into the bond market in order to provide financing. I think we all know the bond market is really struggling right now and generally not open for business. So, as a result, I think, investment bankers are telling their clients, and sellers are seeing that now is not an opportune time.

Now, we do think the first half of the year, Q2 looks like it's going to be equally as weak. Hopefully it starts to ease as the year goes on. But that's going to be predicated on market conditions.

In terms of add-ons, we're working a number of add-ons. These are a little bit different in that these are generally direct negotiated transactions where we're coming up with a list of potential companies that would benefit our subsidiaries. And we continue to work through that. I would tell you that sellers of those businesses are not immune to the same factors that are happening broadly in the marketplace and what's happening in the platform side. And I think, unless we're willing to give credit for some of the pro forma kind of adjustments that sellers would be looking for around normalizing earnings when the supply chain starts to normalize itself, it makes doing transactions more difficult today. That doesn't mean that there is not a robust pipeline and that we're not pursuing them. I think it just means that it's a little bit more difficult to transact in this market.

So, I would say our views and our expectations are muted right now in terms of M&A. And I would suggest that kind of we think this is going to be probably a tough year, but that doesn't mean that we're not out pounding the pavement and working extraordinarily hard to generate M&A opportunities. And if you went back and you thought in 2020, we probably could have singing the same tune on our Q1 earnings call when we were dealing with the pandemic, and why would companies want to come to market in these times and yet we acquired two businesses that were extraordinary. So I don't want to paint a dire picture that it isn't going to be possible.

The truth is when we're in these times in our business model with committed financing and permanent capital, this is really where we shine when our peers are not able to gain access to the financing that they need to transact. This is generally where we're able to come in and acquire businesses that we think are top quality businesses and typically not in as competitive as an environment. So, we're out there working really hard and trying to find new opportunities. And I think, if we can find some, we'll be in a really advantaged position relative to our competitors. But the overall M&A environment remains muted, both for platforms and add-ons.

Cristopher Kennedy
Analyst, William Blair & Co. LLC
Q

Great. Appreciate the color. Thanks, guys.

Operator: Thank you. The next question comes from the line of Robert Dodd of Raymond James. Your line is now open, you may ask a question.

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

Hi, guys. And congratulations on the quarter and the margin performance growth as well. But kind of following on actually to that question, I mean, [indiscernible] (31:26) tough environment multiple [indiscernible] (31:28), et cetera, et cetera, how long do you think the environment needs to remain volatile, disruptive, et cetera, before sellers potentially become little bit motivated, i.e., you may be willing to accept a little bit of a – in the lower multiple when maybe they have capital needs, you have capital, et cetera. I mean, how long would it need to go on before that would really shift in your favor?

Elias J. Sabo

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

A

Yeah. Robert, that's a tough question to answer. I mean, I think you got to – if we look back at history, there's there is some amount of time where a seller needs to readjust expectations and it's difficult. I always say asset prices are sticky on the downside, right, and so when you have expectation that the private market is delivering multiples of whatever X and now it's 80% of X or 70% of X, mentally getting comfortable with that is difficult. And I think it ultimately becomes really a case-by-case decision.

There are some companies that have to transact, you think of competitors that we're typically dealing with in traditional private equity. Well, lot of them have fund life. So if you're at the end of a fund life, you're going to have to sell your business regardless, right, and there's generational changes of assets where you have maybe a founder that wants to kind of get all of their ducks in a row as they're starting to do some estate planning. So there can be specific things that generate deal flow. As you know, though that generally just means that you're sort of looking amongst a smaller funnel, because it's just not as wide open as it's historically been.

My sense is it's going to take the better part. If markets stay volatile like this, if multiples in the public markets continue to contract as they have, it's probably going to take the better part of this year for price expectations to readjust. And then I think there is a point where you just have to kind of give in and say, this is the new environment that we're working in and here is the value that we should expect to receive and we would be happy transacting at. But I can tell you, it's not three and it's not likely not six months, there needs to be a kind of setting in process that happens. Now, we do remain kind of hopeful that the kind of back half of the year gets a little better and then 2023 is meaningfully better. But some of that is going to be predicated on market conditions starting to ease a bit.

Robert Dodd

Analyst, Raymond James & Associates, Inc.

Q

Got you. Very helpful. Thanks. Thanks a lot on that one. On BOA, if I can, and you said it's broad-based strength, but [indiscernible] (34:32) strength there. I mean, are there any, whether it's broad-based, is it broad based across all product types? I mean, obviously, there's different levels of penetration. So it might not be growing as fast, but in geography, I mean any areas that are doing exceptionally well?

Patrick A. Maciariello

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

A

It's across geographies, maybe in this quarter there was a little bit of strength in Asia. And – but that is the thing, right, this BOA is a company whose revenue really sort of comes close to as far as the breakout matching GDP of the globe. And so, it's a much more international business than certain of our other businesses. And so, we have seen strong demand internationally. We've seen strong demand in Europe. We've seen strong demand in Asia. It comes down to the fact, I think, that the sort of performance that rap in BOA's technology, just has a small penetration in overall footwear, right. And if I may, I personally believe it's a lot better product than shoe laces, particularly for performance applications. And we have a lot of data that back that up. So there's market share to be gained in a lot of segments and that's what you're seeing and we believe that we're going to continue to see.

Robert Dodd

Analyst, Raymond James & Associates, Inc.

Q

I appreciate that. And if I can, one more if I can. Lugano, obviously, also do very well. I presume it is the inventory investment is that – it's correlated with the number of salons and growth, et cetera. But is it investing in the same level of inventory per salon or you growing the inventory per salon as well?

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

It's both. It's both. And it's – we're making opportunistic purchases that we can then convey value on to our end consumer that we have a strong relationships with throughout the country. And so it's both of those. There's a certain level of inventory you need when you build a new salon. But we also see that sort of the more inventory we have, the more choices we have for our consumers, the greater amount of activity we're able to see.

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

Robert, I would just say, when we acquired Lugano and we talked to you guys about this originally, we said this is a highly disruptive business model and they approach the industry in a fundamentally different way that dis-intermediated a lot of steps in the process and they deliver a phenomenal value to their end customer as a result. And the demand in that business is really constrained by the amount of investment that we can make in it. And we had said, look, there's a real strong correlation between investing in inventory and having more product availability and revenue profitable revenue growth in that business.

And I think we obviously, monitor this on a real time basis and very closely, but what we've seen is that correlation continues to exist as we put more investment in the business. And when you run the return on invested capital of putting this in, it is so high that the – our goal is to continue to pump capital in until that correlation would break down. The fact that it's not breaking down just means there's significant excess demand that is sitting there and it will be driven – greater revenue and profitable revenue growth can be driven by further investment.

So what we've experienced so far has been exceptional growth. The correlation, if anything, has actually gotten stronger under our ownership, not weaker. And as a result of that we plan on continuing to put significantly greater amounts of capital into our inventory here, because we think demand is significantly greater than what we're currently satisfying. And we think this is going to be not only a big year in 2022, but we think we're setting this company up for multiple years of accelerated growth.

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

I appreciate that color. Thank you.

Operator: Thank you. [Operator Instructions] Our next question comes from the line of Matthew Howlett of B. Riley. Your line is open, you may ask your question.

Matt Howlett
Analyst, B. Riley Securities, Inc.
Q

Hey, guys. Thanks for taking my questions. Congrats. First off, what's the update on the healthcare vertical? I know you're in the market for the team, just want to get the update there.

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

Yeah, Matthew, and thanks for the question. As we've said, we continue to look for the leader. We've got a couple of candidates in mind. We're not ready to make an announcement yet, but that does progress. And we think when we get the right leader that will be something that we are able to launch. We remain confident that we will launch this effort sometime in 2022, but we continue to progress along that, finding that right leader. And I would tell you, for us, we continue to believe having someone with that domain expertise who can come in and be able to guide that effort is incredibly important for us as we go forward in making sure that we're identifying the right assets that kind of fit within our model. And so, we are progressing forward with that. And I'm confident that in 2022, we'll be able to fully launch that effort.

Matt Howlett
Analyst, B. Riley Securities, Inc.

Q

Great. Okay. Look forward to that. On update, or just on interest rates. And at CODI, you did just a tremendous job, refinancing the balance sheet, that's great. My question is around, if the Fed does go to 300 days of short-term, is there any on your – at the portfolio company level, is there any impact that you could see? I know you structured things differently, your company loans and the traditional deal market, but just go over anything if rates do, short term rates go up significantly, what impact would be, is that to your advantage, just maybe walk me through that?

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

A

Yeah. So, as you identified, we hit the market and probably timed it pretty well with the bonds that we issued last year. And kind of in hindsight, we were glad to get that duration into our balance sheet really at pretty much optimal timing. So, we view that as a great asset that we have on our balance sheet. If you remember, those are 8 and 10 year bonds, respectively. So we've got long duration in our balance sheet. And I would point out that we have no short-term debt. And so interest rate volatility today has zero impact on us.

Now, if we were to borrow into our revolver, that is a LIBOR-based or whatever LIBOR, I guess is [ph] phased out (41:54), but it's a kind of an index plus the margin. And so as the index goes up, of course that would be variable rate debt, but we have nothing drawn there. So our interest rate exposure at the parent is zero.

Now, we use mostly floating rate debt as we lend to our subsidiaries in our structure. And so, what would happen theoretically and I think, it's probably more than theoretical in practice, is as the interest expense rises due to the fact that there is kind of a higher base rate that's being charged, right, the index has gone up, that would have the net effect of lowering taxable income at the subsidiary level, and as a result, lowering the amount of tax burden that our companies have. Now offsetting that is that interest expense from the sub comes up to be interest income at the parent, but because the parent absent a sale generates a net loss in a normal year, we think that the effect of rising interest rates will actually in this case, because we were fortunate to lock in with long duration our interest rates last year at the parent, the effect of rising interest rate actually lower the tax expense holistically for the company and raise the amount of free cash flow production that we would be able to generate.

Matt Howlett
Analyst, B. Riley Securities, Inc.

Q

And that's important given your new structure, I mean with your new conversion to C corp. And I got to assume that from a sort of strategic standpoint in the portfolio – when you bid on these portfolio companies, certainly your structures has to be advantageous versus what's traditionally available in the leveraged loan market as rates rise.

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

A

Yeah. I think, well, I mean as I commented earlier, the types of companies that we're typically going after and especially the larger businesses if they're kind of $500 million type businesses, plus or minus, those are companies that largely would be trying to tap into the bond market, maybe the smaller end of the bond market that market is completely been eviscerated. As you know, the leveraged loan market is pretty much on pause right now as well.

And so, our structure, we always say that our business shines in times like this, the higher the volatility, the more advantaged we are as a buyer. We bring certainty to a process. We have committed financing. So if you're selling a business today and you have to go out and rely on financing, the reality is there's a bigger level of risk in that financing being able to come through today than there was a year ago. And so what is the value of the certainty we bring, it's greater today than it was a year ago, I know that, putting a numerical number on that is always hard to do, and it's in the eyes of the seller how much risk they're willing to take.

But our structure is absolutely advantaged from a financing standpoint in times of increased volatility and market uncertainty. Now, I could also say, we just have an advantaged structure in many other respects as well, even when market volatility isn't high, our permanent capital and our mentality of being long-term business builders is something that transcends through all types of market conditions. And it's a massive advantage to us whether we sit in today's market or we sit in a market that was relatively robust from a financing standpoint a year ago. It's why we think permanent capital is really sort of what a lot of people would like to emulate that are competing for these type of assets, because it is so advantageous in terms of not only being able to win companies, but being able to build businesses. But your point of having an exaggerated advantage in these times of market volatility, is spot on.

Matt Howlett
Analyst, B. Riley Securities, Inc.

Q

Great. Thanks for that. And just to just for one further point on that revolver, and clearly you got that at your hip pocket, the accordion feature, well over a billion. I think you've laid out the M&A environment pretty clearly to us, but is there a scenario where you could utilize that this year and go into it, if there was just a tremendous opportunity? Just what should we expect on that revolver being drawn down this year, if at all?

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

A

Well, I think it's going to be predicated on, whether or not we can transact against a meaningful size platform acquisition as to whether we would borrow on that. In terms of cash flow, you heard Pat and Ryan in our scripted comments already talk about the fact that we've made a significant investment in inventory in order to ease supply chain. And frankly, this is something that with the strength of our balance sheet, is a huge advantage for us. And you see it in the results we were able to post in Q1, which were extraordinary in this backdrop, but that is somewhat predicated on the fact that, we did do $1.3 billion of financing at roughly 5% last year in long duration financing. And we're able to use, I think the number is over the last six months, about a $150 million to invest in inventory, to take market share. And that's not only going to pay dividends in Q1 as you saw in over the balance of 2022, but those share gains are going to be here long after supply chains normalize.

And when supply chains normalize, as Ryan said, we expect to monetize a big part of that kind of inventory investment that we've made to get through these times. So, if I look at our business today and I say, on the one hand, we have inventory investment that we made a huge investment in over the course of the last six months, likely we have enough inventory. And I'm going to exclude Lugano from that because I just went through the correlation of how Lugano's inventory investment drives really high return on invested capital growth in that business. So, let's separate that for a second. The remainder of the business, frankly, has adequate inventory and if anything, is likely to be monetizing over the balance of the year and into 2023. So, that's a cash flow positive.

You also have our business, which we had said with the change in the corporate structure, is now a meaningful free cash flow, [indiscernible] (48:33) working capital provider. And so, we've got high free cash flow production that we're creating. You've got working capital that should be a cash producer, not a cash user. Now against that we have some elevated CapEx for 5.11 in Lugano, which we think is very high return CapEx and we have investment in further inventory growth at Lugano, which is extremely high return on invested capital. But the net of that should be positive free cash flow going forward. So, the use of the revolver really is a function of how much we can deploy into either add-ons or new platform acquisitions.

Matt Howlett
Analyst, B. Riley Securities, Inc.

Q

Yeah, looking at [indiscernible] (49:16) return on invested capital. I really appreciate it guys. Thank you.

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

A

Thank you.

Operator: Thank you. The next question comes from the line of Tim Long of Adirondack. Your line is now open, you may ask your question.

Tim Long
Analyst, Adirondack Research & Management, Inc.

Q

Thank you. I'm going to try on BOA again. Hopefully, you can help me out. How much of the growth was, I guess, let's call it, seasonal, the obvious seasonal drivers? And then second derivative, how much of the growth was, call it, existing product platforms, verticals, however you want to describe it and product extensions with existing customers? And then maybe how much was with brand new customers I guess? I don't know if you can kind of parse it a little bit better.

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

A

Yeah. Tim, its Elias. And I guess, a long time I haven't seen you. Hopefully we'll reconnect at a conference here one of these days.

Tim Long
Analyst, Adirondack Research & Management, Inc.

Q

When I find management that execute, I get out of the way.

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

A

Good. So, maybe I don't want to see you then at a future conference. But to your question, I would say, we look at it a little bit differently. And when we acquired BOA, we had said, what are the things we really like about it? It's a disruptive technology that is for the most part upending an industry that hadn't had innovation that came in in 100 years. It is a performance enhancement, so it's not just a convenience product. And that really is kind of very important here and we now have a lot of documentation around it, and we work with a broad range of partners.

And within that it's a global business, where I think US is probably the smallest market in end market that we actually deliver product to. And then we couple out with one of the best, if not the best management team that I've ever worked with. And I think that creates really explosive underlying organic opportunities. So it's hard to parse out with all the different things that you said. But what I would say is, the market share of this business is around 5% of its addressable market. And it's got incredible IP, over 160 patents that we have globally issued. And so it has really the elements that you would look for, for being able to drive sustainable long-term growth.

So, I would say that every year, we work with our brand partners to extend our technology on additional platforms that they have. And that is an ongoing thing that we do year in, year out. And in addition to that, our management team has done an exceptional job of being able to get into new industry verticals, and each one of those are at different levels of their maturation. So if you took snowboard where the company started, we have a very high level of market penetration and by definition, that means the opportunities and the growth rate in that business are going to be less. But we have ceded market and if you call them verticals or whatever you want to call them, we've really have a – the management had the foresight to seed a lot of different verticals and they are at different stages of their maturation process.

So what we see with this company is that it's sort of a little bit of everything that you said, except we're really not bringing a lot of brand partners into the fold. We have so many outstanding opportunities with our brand partners to be able to expand on new platforms that they have. And then, of course, when we get on those new platforms, the ultimate thing that drives this business and it's like in any consumer product, if we put our – if we partner on a new platform, how is that product going to do to the end consumer? And what we find is that product does really well and takes market share in its own little area when we're on there.

So it's a little bit of everything that you said, probably not as much in terms of getting new brand partners, because we have the brand partners that we want to work with. Of course, there's probably some here or there that we add into the fold, but mostly it's we're taking market share from a relatively small point right now with a disruptive technology and a outstanding management team, and great IP position. But we think those continue to be all the elements for making a company that has long-term sustainable growth opportunities.

Tim Long
Analyst, Adirondack Research & Management, Inc.

Q

Translation. It's very early innings and the runway is really long. You don't need to start dissecting this that closely, because there's just a lot on the plate, a lot of opportunity. Keep up the good work, guys.

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

A

Yeah. Tim, you just said what it took me 5 minutes to say in 10 seconds, maybe I'll turn the call over to you, something like that. But yeah, that is 100% correct.

Tim Long
Analyst, Adirondack Research & Management, Inc.

Q

Super. Thanks.

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

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. Thank you for your continued support.

Operator: Ladies and gentlemen, that concludes today's conference call. Thank you all for participating. You may now disconnect.