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Compass Diversified NYSE:CODI

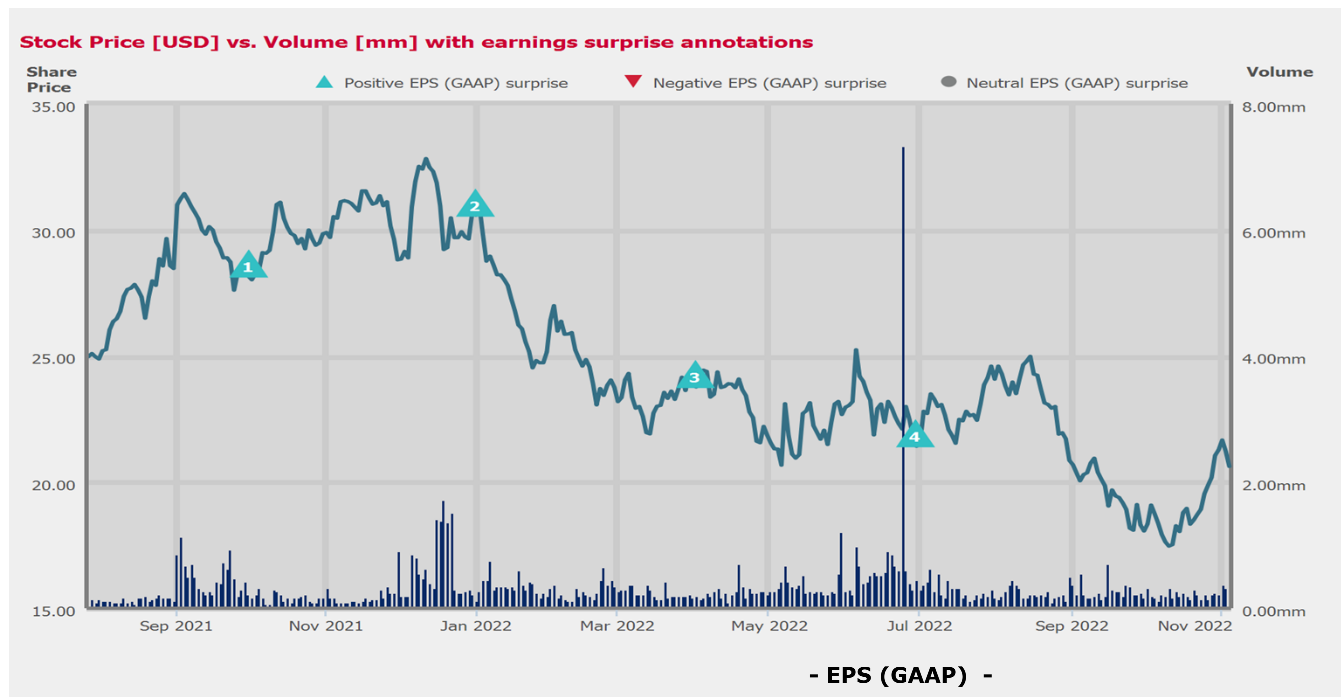
FQ3 2022 Earnings Call Transcripts

Thursday, November 03, 2022 9:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ2 2022-	-FQ3 2022-	-FY 2022-	-FY 2023-
	CONSENSUS	CONSENSUS	CONSENSUS	CONSENSUS
EPS (GAAP)	0.11	0.10	0.87	0.96
Revenue (mm)	502.15	549.05	2186.30	2421.19

Currency: USD
Consensus as of Nov-02-2022 4:03 AM GMT



- EPS (GAAP) -

	CONSENSUS	ACTUAL	SURPRISE
FQ3 2021	0.35	0.97	▲1 177.14 %
FQ4 2021	0.20	0.33	▲2 65.00 %
FQ1 2022	0.08	0.34	▲3 325.00 %
FQ2 2022	0.11	0.38	▲4 245.45 %

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Call Participants

EXECUTIVES

Elias Joseph Sabo
Partner, CEO & Director

Patrick A. Maciariello
Partner & COO

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

ANALYSTS

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

Lawrence Scott Solow
CJS Securities, Inc.

Matthew Butler Koranda
ROTH Capital Partners, LLC, Research Division

Matthew Philip Howlett
B. Riley Securities, Inc., Research Division

ATTENDEES

Cody Slach
Gateway Group, Inc.

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Presentation

Operator

Good afternoon, and welcome to Compass Diversified Third Quarter 2022 Conference Call. Today's call is being recorded. [Operator Instructions]

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

Cody Slach
Gateway Group, Inc.

Thank you, and welcome to Compass Diversified's Third Quarter 2022 Conference Call. Representing the company today are Elias Sabo, CODI's CEO; Ryan Faulkingham, CODI's CFO; and Patrick Maciariello, COO of Compass Group Management.

Before we begin, I'd like to point out that the Q3 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 compassdiversified.com. The company also filed its Form 10-Q with the SEC today after the market closed, which includes reconciliations of certain non-GAAP financial measures discussed on this call and is also available at the Investor Relations section of the company's website.

Please note that references to EBITDA in the following discussion 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, the impact on expected timing of acquisitions and dispositions and future operational plans such as ESG initiatives. Words such as believes, expects, anticipates, 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 September 30, 2022, as well as in other SEC filings.

In particular, the domestic and global economic environment, supply chain, labor disruptions and inflation, all may have 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 Joseph Sabo
Partner, CEO & Director

Good afternoon, everyone, and thanks for joining us today on our third quarter 2022 conference call.

I am pleased to report that we delivered another exceptional quarter with third quarter revenue and pro forma combined subsidiary EBITDA increasing by 15% and 16%, respectively, over prior year. Q3 marked our seventh consecutive quarter of double-digit consolidated pro forma subsidiary EBITDA growth. Notwithstanding the difficult macro climate, the strength of our year-to-date operating results is enabling us to raise our 2022 outlook once again.

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The macro environment has created significant challenges and distortions over the past few years. The effects of the pandemic on the global economy were profound, and we continued to wrestle with headwinds stemming from the pandemic. Throughout much of 2022, we dealt with erratic supply chain, labor shortages, and inflation running at 40-year highs.

Despite these challenges, we generated record year-to-date operating results, which is a testament to the competitive positioning and management strength at our subsidiary companies. As we finish 2022 and enter 2023, we faced new macro-led challenges. Supply chains are starting to normalize, but labor markets remain unbalanced and inflation continues, particularly in wages.

Global demand has eased with Europe showing significant weakness and Asia's growth becoming more erratic due to China's zero-COVID policy. Domestic spending has remained strong amongst the more affluent consumer, but we have seen a large decline in discretionary purchases for price-sensitive shoppers. Together, these macro issues pose a difficult challenge as we finish 2022 and enter 2023.

Despite these challenges, we believe CODI is positioned to outperform in both good times and bad times. We own a collection of subsidiaries with diverse end markets, business cycles, investment cycles and inventory cycles, amongst others. This diversification proved to be essential during the pandemic, where we produced growth in 2020 against a very difficult macro backdrop.

As you are aware, a strategic initiative of ours has been to launch a health care vertical. This afternoon, we announced that effective November 1, Kurt Roth has joined our team with responsibility over our health care initiative. Kurt brings a wealth of health care investing and transaction experience, having previously worked closely with the Compass team during his tenure at Robert W. Baird.

Most recently, he spent the last 7 years as Head of Corporate Development and Strategy with Sotera Health, a leading global provider of mission-critical, end-to-end sterilization solutions, lab testing and advisory services for the health care industry. During his tenure, Sotera consistently grew revenue and expanded profitability while developing a successful track record of identifying, completing and integrating strategic acquisitions.

We are delighted to have Kurt join our team. Not only does he possess the skills to build our health care vertical, but more importantly, he aligns with our culture and values.

Health care is an important initiative that will allow us to see a significant increase in actionable opportunities. The health care industry is large and growing rapidly. And we believe the acyclical nature of the industry will add to the diversification of our subsidiaries and further decrease our financial volatility.

As we have also stated on prior calls, the subsidiary company transformation over the past few years has created a much faster core growth rate. I would like to highlight that 4 of our subsidiaries, BOA, PrimaLoft, 5.11 and Lugano, are all rapid market share-taking businesses with low penetration in industries with positive long-term macro trends. These 4 businesses represent over 50% of our consolidated subsidiary EBITDA, and we believe their ability to continue to take share at a rapid pace will both soften any reduction in demand while accelerating the growth rate in stronger times.

Before I turn the call over to Pat, I want to discuss the recent shifts in the capital markets and the implications as we head into 2023. As we are all aware, the Federal Reserve has aggressively tightened monetary policy in an effort to ward off high inflation. This has, in part, caused a major correction in the stock and bond markets with the bond market indicating the likelihood of a recession in 2023.

Broadly, we have seen a reduction in new orders across our subsidiary companies. However, end market demand for the majority of our goods remains strong. We believe a period of inventory deaccumulation is taking place, first, as the supply chains are normalizing and companies are moving back to more just-in-time inventory; and second, as fears of an economic slowdown are causing companies to plan inventory more carefully.

Taking these factors into consideration, we are planning for a more challenging demand environment in 2023 with easing supply and inflationary pressures. Notwithstanding a weaker demand outlook, we are

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confident in our company's competitive positioning and market share growth and believe we are poised to outperform our peers.

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

Patrick A. Maciariello
Partner & COO

Thanks, Elias. Throughout this presentation, when we discuss pro forma results, it will be as if we own PrimaLoft and Lugano from January 1, 2021. On a combined basis, revenue and pro forma adjusted EBITDA in both our branded consumer and our niche industrial business grew and continued to exceed our expectations. Once again, third quarter EBITDA growth exceeded revenue growth as our higher-margin businesses outpaced the group as a whole.

Before I get to our subsidiary results, I wanted to provide a high-level view of the quarter's results.

As Elias alluded to, several of our companies who sell to retailers focused on mass channels continued to face pressures as their consumers remain impacted by inflation and retailers continue to focus on reducing inventories. These headwinds were most acutely felt at Sterno, Velocity and Ergobaby.

In addition, currency headwinds increased in the third quarter and impacted several of our subsidiaries. Despite these challenges, on a consolidated basis, we were able to achieve meaningful growth in the quarter. Once again, our management teams executed well for their customers and employees, and we are proud to be their partners.

Now on to our subsidiary results. I'll begin with our niche industrial businesses. For the first 9 months of 2022, revenues increased by 13.2%, and adjusted EBITDA increased by 10.8% versus the year-to-date period of 2021. Arnold and Altor posted meaningful revenue and adjusted EBITDA growth. Arnold continues to show improving margins driven by technology investments made over the last several years. Additionally, the company continues to have meaningfully positive book-to-bill ratios as demand for its technology, which enables efficiency gains in numerous industries and applications, continue to increase.

As we mentioned last quarter, the company is comping against a very large defense-related order in the back half of last year, which should have solid performance in the fourth quarter.

Altor once again had solid growth partially driven by its acquisition of Plymouth Foam in the fourth quarter of 2021. Though margins remain pressured by higher raw material prices at Altor, gross margins ticked up sequentially, and we expect them to continue to improve in Q4.

The Sterno Group faced some challenges in the third quarter. Though the foodservice portion of the business continues to return to normalcy post pandemic and we expect a strong fourth quarter in that segment, the company is seeing pressure in sales of its value-driven line of scented waxes. These pressures are a result of both inflation impacting end users and retailers focusing on driving down inventory levels as discussed earlier. We expect these pressures to continue in the near term.

Turning to our consumer businesses. For the year-to-date period, revenues increased by 16.5%, and pro forma adjusted EBITDA increased by 18% as compared to the same period in 2021. BOA had another very strong quarter of performance. And for the year-to-date period, revenue is increased by 38.5% and EBITDA by close to 50% from the same period last year. In the fourth quarter, we expect BOA to be approximately flat to last year as the company comps against a very strong Q4 '21.

However, we want to recognize that the full year of 2022 has been an exceptional year of growth, and our second full year partnering with the company. We remain enthusiastic about BOA's expansion in new adjacent categories and believe the company will continue to gain market penetration in the years ahead.

Lugano's growth accelerated in the third quarter, and the company has now grown both revenue and pro forma adjusted EBITDA for the year-to-date period by close to 70%. We benefited in the quarter from both the opening of our new Houston salon and from an increase in average transaction size.

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Lugano is starting the fourth quarter well, and we plan on opening our new flagship Newport salon before year-end to continue -- and to continue expanding geographically in 2023. We believe that Lugano possesses a disruptive business model, and we will continue to support the company with investments in inventory, people and new salons.

Marucci also had an exceptional quarter as the launch of the highly anticipated CAT X line of bats was above expectations. For the year-to-date September period, Marucci's revenue and EBITDA grew by 41.9% and 13.2%, respectively. Margins improved in the quarter as the supply chain-related issues we experienced in the first half of the year began to somewhat dissipate. Marucci is also having early success entering several new markets including fielding gloves and fastpitch softball, and we are confident these adjacent categories will be drivers of further growth.

Turning now to our most recent acquisition, PrimaLoft. For the year-to-date period, pro forma revenue and EBITDA increased by 25.8% and 33%, respectively. For the third quarter, on a pro forma basis, revenue and EBITDA were approximately flat with 2021 levels. Due to the seasonal nature of PrimaLoft's outerwear-driven business, the second half of the year typically accounts for less than 1/3 of full year EBITDA.

Booking and quoting trends are solid heading into 2023, and we remain pleased with the PrimaLoft acquisition and optimistic that they will continue to take market share.

Touching briefly on 5.11. We are proud of the company's performance in a difficult environment for apparel businesses. For the year-to-date period, revenue and EBITDA grew by 9.2% and 3.4%, respectively. Despite the headwinds in the industry, 5.11 continued to grow in the third quarter, and its direct-to-consumer comps remained meaningfully positive. We continue to be excited by the brand's potential and believe the business remains well positioned for continued growth.

As a whole, we were very pleased with the performance of our businesses in the third quarter. As Elias mentioned, we believe there will be continued economic headwinds in the fourth quarter, but on a consolidated basis, CODI is well positioned to weather these storms and have solid performance.

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

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

Thank you, Pat. On to our consolidated financial results for the quarter ended September 30, 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, Third quarter revenue was up 22% to $597.6 million compared to $488.2 million in the prior year period. This increase reflects the company's acquisition of PrimaLoft in July 2022 and as well as the strong double-digit revenue growth from BOA, Lugano, Marucci, 5.11 and Altor. On a pro forma basis, assuming we had acquired Lugano and PrimaLoft on January 1, 2021, net sales were up 15% compared to the prior year period.

Consolidated net income for the quarter was $2.6 million, down from $90.1 million in the comparable year-ago quarter. As a reminder, Q3 last year included a $72.7 million gain on the sale of Liberty Safe.

As introduced earlier this year, we believe adjusted earnings and non-GAAP financial metric, will allow investors to assess our operating performance in a more meaningful and transparent way. Adjusted earnings for the quarter was $46 million, up $10.1 million or 28% from the year ago quarter. Our adjusted earnings generated during the quarter were above our expectations for the reasons previously highlighted by Elias and Pat. In addition, our adjusted earnings were positively impacted by a $3.5 million income tax benefit at PrimaLoft, primarily due to the acquisition costs expensed during the quarter.

I'll provide an update on our adjusted earnings guidance shortly. Before I get to our balance sheet metrics, in this rising interest rate environment, I want to highlight how fortunate we are to have placed $1.3

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billion of bonds on our balance sheet in 2021 at a blended fixed rate of 5.2%, representing 70% of our total outstanding debt and with maturities of 2029 and beyond.

Now to the balance sheet. As of September 30, 2022, we had approximately $61 million in cash, $113 million drawn down on our revolver, $397 million in term loans and total leverage of approximately 3.9x. We had $485 million available on our revolver, and we have the ability to upsize our revolver capacity by an additional $250 million. With this substantial 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 third quarter of 2022, we used $4.6 million of cash flow from operations. Our cash earnings during the quarter were able to fund our working capital needs, which were primarily directed towards our strategic inventory investment at Lugano. In addition, many of our consumer companies experienced strong revenue growth, which required working capital investments. While this is a seasonally high point for inventory levels, our management teams are closely monitoring their inventory to ensure we meet consumer demand without a negative financial impact.

And finally, turning to capital expenditures. During the third quarter, we incurred $15.1 million of CapEx for our existing businesses compared to $11.4 million in the prior year period. The increase was primarily a result of the continued retail store expansion at our Lugano and 5.11 subsidiaries. For the full year of 2022 we anticipate total CapEx investments of between $50 million and $60 million. The capital expenditure spend in the fourth quarter will be primarily for Lugano's new expanded headquarters in Newport Beach. In addition, we will continue to support 5.11's retail store expansion from its current 107 stores.

Now on to our adjusted EBITDA and adjusted earnings guidance. Despite our excellent performance in the third quarter, we remain in uncertain times, driven by market volatility, inflationary pressures impacting consumer behavior and labor shortages amongst others. However, as a result of our company's strong performance in the third quarter that exceeded our expectations and our current view of the economy, we are once again raising our 2022 full year consolidated subsidiary adjusted EBITDA outlook.

Our previous range was $445 million to $470 million. Our revised range is $460 million to $470 million. At the midpoint, this implies year-over-year growth in subsidiary adjusted EBITDA from 2021 on a pro forma basis to include PrimaLoft of 12%.

Next, I'd like to discuss adjusted earnings. As Pat mentioned earlier, PrimaLoft generates its strongest earnings in Q1 and Q2, given seasonality of ordering for the outerwear industry. Further, because of a significant income tax benefit at PrimaLoft that I mentioned earlier, coupled with strong performance across our subsidiaries, our Q3 adjusted earnings were significantly above expectations.

As a result of these items, our revised full year adjusted earnings guidance range will move from our previous range of $130 million to $145 million, upwards to $145 million to $155 million. The midpoint of our adjusted earnings range implies a 10% increase from the prior year. We anticipate our fourth quarter adjusted earnings will be down from prior year, primarily as a result of PrimaLoft seasonality as well as higher interest costs from funding the PrimaLoft acquisition and increasing rates on our term loan and revolver credit facilities.

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

Elias Joseph Sabo
Partner, CEO & Director

Thank you, Ryan. I would like to close by briefly providing an update on the M&A market and our strategic initiatives. M&A activity remains significantly below historic levels. Potential sellers remain hesitant to begin processes given the economic headwinds and the macro backdrop. We anticipate the remainder of this year to be extremely slow, with a gradual increase occurring in 2023 if economic headwinds start to moderate.

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Strategically, we continue to focus our internal efforts on the development and implementation of our ESG strategy. During the third quarter, we spent a significant amount of time working with our subsidiaries to understand how our overarching ESG framework will be implemented into our companies.

We believe that the environmental, social and governance standards that we use to build our framework will allow us over time to deploy capital in a different way than many in the marketplace in a way that we think reflects risk more appropriately.

We believe the implementation of our ESG framework requires Board involvement and oversight. In the last quarter, our Board has undergone training regarding proposed climate disclosure reporting regulations, and we continue to build out and enhance the learning process so that our Board understands the risks and opportunities.

In our most recent Board meeting, we presented our ESG framework, and we received buy-in from our directors as we proceed to implementation.

Finally, we believe health and well-being should be a priority for all. In line with the World Health Organization objective to raise awareness of mental health, we have adopted a Health and Well-being Month during the month of November, which will become an annual event. This campaign aligns with one of our key ESG imperatives of future proofing for our people and planet, specifically our focus on health and well-being and attracting and retaining the best talent.

In conclusion, it was another great quarter for CODI. Relative to our expectations, our performance was once again outstanding. Our management teams and employees continue to put forth incredible effort, and I'd like to give thanks and recognition to all of them.

Before turning over to Q&A, I'd like to briefly mention that we will be hosting our Investor and Analyst Day in New York City on January 19, 2023. We will be highlighting each of our consumer companies with a more detailed showcase of PrimaLoft's products, including a presentation from Mike Joyce, PrimaLoft CEO. More details to follow in the coming weeks, but we hope to see you all there.
With that, operator, please open up the line for Q&A.

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Question and Answer

Operator

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

Lawrence Scott Solow
CJS Securities, Inc.

Great. Elias, you mentioned supply chain issues starting to improve a little bit, but there's still obviously a lot of disjointed stuff. And it sounds like the labor market is still very difficult. How about you guys specifically? Are there any companies that are disproportionate in your subsidiaries still feeling that supply could impact challenges more so than the average?

And have you been able to -- obviously, labor costs are higher, but have you guys been able, for the most part, been able to hire satisfying amount of people? Or do you have a lot of shortages across some of your companies?

Elias Joseph Sabo
Partner, CEO & Director

Yes. I'll let Pat talk about supply chain by company. I would say in terms of labor markets, Larry, they continue to remain out of balance. I think it's one of the bigger issues clearly on the -- at the macro level. Wage inflation is running extremely high. I think we all saw the JOLTS data the other day and ADP with almost 8% wage inflation year-on-year.

It's quite troubling, I would say, when we see this kind of imbalance. There has been some additional hiring that we've been able to. I would say it's company-by-company experience. It's not broadly in universal. There's still a lot of openings. There's still a lot of overtime that is being asked, which is really inefficient from both a cost and productivity standpoint.

So I'd say it's not only wage inflation that is problematic here, but the fact that there's just not enough labor for the available spot continues to be an issue. I think there's been some marginal improvement on labor availability, but it's not material.

In terms of supply chain, Pat, what are we seeing in terms of company -- companies that are struggling still more so than the average?

Patrick A. Maciariello
Partner & COO

Yes. I mean it's everybody is still struggling and it is getting better. It's definitely getting better everywhere at each of our 11 businesses, though there's challenges at each of the 11. A couple I would point to that may have had higher revenues, if not for the supply chain issues, though, would be Velocity where we manufacture a lot of sporting goods equipment. Oftentimes, you have 99% of the product done, but you're waiting on one piece, and that cost us some revenue this quarter as we just didn't have that one final piece to assemble it.

I would also say at Advanced Circuits, we have a large assembly business where we assemble componentry for our clients. And again, you have hundreds of pieces on a product, and you have 99% of those in, but you don't have the 100. And so you can't ship the product. So those are 2 things that stand out is where we probably missed out on a little bit of revenue this quarter, if that's helpful, Larry.

Elias Joseph Sabo
Partner, CEO & Director

In general, Larry, supply chains are easing, and shipping costs have come back to prepandemic levels. Port congestion has really been reduced, and we're getting a good flow coming out of the ports and getting into our warehouses. So yes, are there a couple of continuing minor issues that are experienced

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in the third quarter? Yes. Could there even be a little bit of problems existing in the fourth? Probably, but even less so.

I think the point to take is that supply chains are clearly normalizing -- and I think now on the other side, it's probably allowing companies to deaccumulate inventory a little bit because supply chains are normalizing. So, I think, those 2 things go hand in hand, and that's likely going to put system-wide, some pressure down on order demand as companies are able to work down some of that inventory and manage more just-in-time based on a more efficient supply chain again.

Lawrence Scott Solow
CJS Securities, Inc.

Got it. Great. And just one more -- just a quick follow-up just on a consumer question just on BOA. Obviously, really impressive growth this year. I think it's close to $70 million year-to-date EBITDA. It seems like your visibility is pretty strong, multiyear strong visibility. I mean I guess the growth may slow next year. I don't expect it to double again, but -- it sounds like you guys feel like maybe this was an outsized year, but it doesn't feel like we're going to contract or anything next year, right? Maybe just the growth may slow a little bit. Is that sort of fair?

Elias Joseph Sabo
Partner, CEO & Director

Yes, Larry, I think when you think about BOA, and we really wanted to highlight for everyone, not only BOA but PrimaLoft, 5.11 and Lugano, we put all 3 of those into companies that have relatively low market share in their respective industries, but also are really fast market share takers.

So take BOA as an example. BOA's market share is under 5% today, but it's got disruptive technology. When people experience using the product in a category, if you're a golfer, and you use the BOA product and then you go do a Peloton ride, you're probably likely to watch the product for a Peloton as well.

And so as we get into more of these categories, there's a huge TAM that's out there. The product is, as I said, a really exceptional and people love it and it's very disruptive to the 100-year old kind of noninnovated [lathe industry]. And so it may be an easy target that we're going after.

But when you have those kind of dynamics, a disruptive product with low market share, and your gains in market share are allowing you to have accelerated revenue gain at the company well in excess of what the industry is, right? I mean the industry isn't growing 20%, 30% like BOA is. All of that growth is being enabled by market share.

It's hard when you look and say, "Well, [with sub] 5% should growth start to really wane, we just are still so kind of underpenetrated relative to our potential, we think there is really good legs for long-term accelerated growth in this business.

Now if I want to take a much more narrow view at Q4 or the first half of 2023 or even all of 2023, look, it's hard to tell what our partners are going to do. It's hard for us to know how much inventory they brought in and what they need to work down through the supply chain.

So clearly, inventory deaccumulation can negatively, in the short term, impact the strength of growth. But I would say there's no view that BOA or any of those 4 businesses that we mentioned, which represent over half of our EBITDA, there's no view that these companies are taking market share and going to continue to take market share at a rapid pace.

And we may have a year or a period of time or 6 months, whatever it may be, where there are some factors that hold that growth back somewhat. But the intermediate to long-term growth trends for BOA and the other 3 remain absolutely intact. And there is nothing that makes us less excited about that company as we stand today or the other 3 or any of our companies, to be honest with you.

But there's nothing that makes us less excited about BOA right now than where we were 3 months ago, a year ago or upon the acquisition. I mean, this is a great company and we believe has accelerated revenue and EBITDA growth potential for years to come.

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Operator

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

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

Can you talk a little bit about the health care strategy, kind of what areas is Kurt going to be focused on and kind of the timing of his onboarding and when we might see something within that area?

Elias Joseph Sabo
Partner, CEO & Director

Sure. Thank you, Cris. And Kurt is here with us today. He joined on November 1, 2 days ago. As I mentioned in the prepared remarks, we've worked with Kurt for a number of years, so we know him. And I think it's really great when you can work with someone who you know fits culturally in with what you are doing.

When we think about the health care kind of vertical and industry, one, we talk about actionable opportunities, I think in 2021, there was north of it. Yes, there were 1,700 -- I don't know if that's exact. But let's say, north of 1,500 kind of control transactions that occurred, which is really an incredible number. So we think at the top of the funnel, there's the ability to have a lot more opportunities to be seen.

And as you know, we have a pretty tight lens in terms of -- and filter in terms of what can make it down through to an opportunity that we want to ultimately close on. But this industry, I think, serves up enough opportunities for us to be able to meet our criteria and still be quite active.

In terms of what we're looking for, I can tell you pretty definitively what we don't want to do, and that is we don't want to take binary risk in anything. So we're not going to go into biopharmaceutical development or medical device where you either hit it and it's a home run or it's a 0. That's not what we're set up and established to do. That's much more venture capital than us.

So when you take out all of sort of that drug development, medical development kind of area, that obviously is going to narrow down kind of the view that we look at. It really leaves sort of a broad area of services that we would like to be focused on. And I would say within the service space, it's a huge area. There are a lot of essential services that are done on behalf of, whether it be hospitals, outpatient centers, pharmaceutical companies, medical device companies. There are essential services that exist out there that are continuing to grow and are not subject broadly to government reimbursement. We think those are the type of companies that really lend themselves well for kind of controlled transaction and investment like we would typically consider.

In terms of your question on when we can expect to put capital to work and have something, I mean, Kurt just joined 2 days ago, so I think it's a little premature to be thinking about that. Obviously, we have a team here who will be drawing from a lot of the resources that we have. We have a business development team that will be making a lot of contacts and has been already working in the health care area. The bankers and the other deal intermediaries know that we're going to be active here.

But I would say in terms of a deal, it's going to take a little bit of time in order for us to get fully up to speed and running. I would hope that happens in 2023. But as we said earlier, the M&A market is frozen shut right now. And we are seeing virtually nothing come through from the sell side. And so we can't create something out of nothing clearly. And the longer we stay in an M&A freeze, the longer delayed we will be before we're able to kind of put money to work in the health care vertical. And that's a little bit outside of our control.

I think we need to probably see the Federal Reserve pause or at least become less aggressive in monetary policy. We need to see how that's going to impact the economy. And then I think deals will start to open up and come to market. And we'll be in a position when that happens. But I think everybody should know,

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the near-term outlook for M&A, whether it's in health care, consumer or industrial, it's quite limited right now.

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

Understood. And then just a quick follow-up. In terms of strategic add-ons, is that still frozen as well? Or are there still opportunities happening?

Elias Joseph Sabo
Partner, CEO & Director

I mean we're always looking for add-ons, but unfortunately, the same dynamics that are affecting the platform market is affecting the add-on market. I think the add-on market because it's smaller and it's so entrepreneurial, typically can be a little different than the platform market. And so there is some marginally better activity levels there. But even sellers in the add-on, potential add-ons, they understand that the stock market is down 20% year-to-date.

Bond market is an accommodated financing [indiscernible] and they may not be big enough to achieve bond financing. But I think you can see the headlines, you can see the macro. And just broadly, sellers are hesitant to come and initiate a process right now even an add-on process.

Operator

[Operator Instructions] Your next question comes from Matt Koranda with ROTH Capital.

Matthew Butler Koranda
ROTH Capital Partners, LLC, Research Division

Just wanted to follow up on some of the comments that Elias made earlier. I guess what I was curious about with the inventory destocking that you mentioned is, just how are you preparing your subsidiaries for sort of inventory destocking at their customers? Who's most prepared at the moment in the subsidiary landscape and then who may need a little bit of work on that front? And then I have a follow-up as well.

Elias Joseph Sabo
Partner, CEO & Director

Sure. I'll let Pat handle that.

Patrick A. Maciariello
Partner & COO

Yes. I mean we've broadly looked at the length of the supply chain for each subsidiary, again, by subsidiary, right, and figured out sort of what that meant. And if it's a business that's characterized by a lot of overseas, and there was a lot on the overseas. Just think about what that would be as far as a headwind. I don't think I'm going to touch on. We think we're -- each of our subsidiaries is better prepared than their competitors in the space and we focus hard on it, and we have focused hard on it, and we'll continue to focus on it as we go into budgeting season. But I'm not going to comment sort of on the specifics.

Elias Joseph Sabo
Partner, CEO & Director

And I think just overall, Matt, what we're seeing is, and as we've talked to our subsidiary companies, we just have to be prepared for whatever comes in the back half of '22 here and into '23 and it's quite uncertain. We think inventory destocking is happening now.

We know in some of our companies where we get point of sale versus what ours are, and we see a divergence of those, so we already know in some businesses, that we're seeing a certain amount of destocking happening in Q3 and Q4, and that could bleed into early 2023. I would say end demand continues to remain relatively strong.

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Now there are pockets of weakness. Europe is weak. Asia is relatively weak. The more price-sensitive shopper is weak, but where the vast majority of our products go, which are domestic consumption by a more affluent customer, that end demand has stayed really strong and probably will continue to stay strong. If you think that consumer also has a job -- jobs are really plentiful. Wages are going up a lot. Their wage growth is higher than the inflation that they are experiencing, so there's no need to reduce discretionary spending. So that's sort of where we stand today.

But as we look into early 2023, none of us know any better than you guys on the call what this experiment of the government printing trillions of dollars pumping it into the economy creating massive inflation and then having to reverse course, what that's going to bring?

And so we have to be really cautious and we have to be ready to move quickly. I would say the bigger picture and when you say, how are your companies dealing with this inventory deaccumulation, it really is a question of how are our companies preparing for a potential reduction in demand that could result either from inventory destocking or a hard landing driven by the policies of the Federal Reserve.

And as we did in 2020 and as we did in the prior recessions -- in the financial crisis in 2009, we move quickly and try to be proactive with our companies to say, look, we need to be -- we need to pull back quickly on spending if we see that our demand isn't materializing. And so there are certain things that our companies like to do for more intermediate and long term. Those are the things that start to get pulled back to the extent you have demand weakening.

So I would say, right now, end market demand for our products, I want to get this across again at the expense of maybe being redundant end market demand for the majority of our products is really good. But we're being cautious, and we're not saying to our companies -- and with our management teams, now is the time you need to start pulling back but you need to be watching everything really closely, and we need to be prepared to pull back and manage costs more tightly if demand starts to slow down, which the markets are suggesting, even though we're not seeing it, the markets are suggesting that.

And I would just say, we as a management team and our subsidiary management teams are all committed to being on very vigilant and on high alert right now to see which direction the economy is going to go based on macro policies that are being implemented principally by the Federal Reserve.

Matthew Butler Koranda
ROTH Capital Partners, LLC, Research Division

Makes a lot of sense. Thanks for all the details. And then just was curious about your willingness or posture towards doing any opportunistic divestitures to sort of delever the balance sheet in the near term or set yourself up for some of the incremental acquisitions that may come from the medical side.

And then any update to your leverage targets, just given the higher rate environment and the incremental loan on revolvers is going to be a little bit more expensive on a go-forward basis. So any updates to sort of how we should be thinking about leverage and willingness to go lower on leverage in a higher rate environment?

Elias Joseph Sabo
Partner, CEO & Director

Yes. So first, in terms of opportunistic divestitures, we -- you know this about us. Everything is for sale at the right price. And so if we can find the right opportunity and the right buyer that finds value that we think is accretive for our shareholders, we are always open to that, but it clearly has to be in any company that we would consider a divestiture, something that is value accretive to our shareholders overholding that business. And that's a pretty high bar. And so it feels like a stretch for us to be able to achieve that in an environment that is this negative and where multiples have contracted so hard.

I mean we can look at a lot of public companies and heck, you're seeing multiples contract 30%, 40%, 50%, 60% in a lot of businesses, I think, it would be difficult to achieve sort of the valuations that we would expect for our businesses in today's environment. Not to say that that's not possible, I just would think that it's difficult to anticipate that.

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And so we're always open. I would say when markets come back, there'll be some companies that strategically we think make more sense than others. And so we'll always consider that, but it doesn't seem to be a likely target right now.

In terms of our leverage, and I can let Ryan speak to this as well. Our target remains 3.5. Understand we have over 70% of our total obligations fixed right now. which in hindsight now looks like a very good kind of move we made last year. So we aren't overly exposed to higher borrowing costs. Yes, will we have a little bit of higher borrowing cost? Of course, because on the 30% that's not fixed, those rates are going up. It was anticipated.

Most of that debt was placed for the PrimaLoft acquisition. And so we feel very comfortable that PrimaLoft's earnings and earnings growth, we'll be able to cover any additional costs that we have on that floating rate debt. But we are not changing our leverage policy.

We do remain a little bit above what our target leverage is. But given growth in the portfolio and given our cash flow that we produce now from operations, we feel comfortable with where we are. Ryan, any additional thoughts on the balance sheet?

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

Yes. Just the only other thing I'd add to is just simply, we've been investing pretty heavily into the growth of the subsidiaries, and that's certainly added working capital into the balance sheet. And that we are at a high point right now seasonally. So we've got cash conversion that should occur over the next couple of quarters. And at the same time, investing in businesses that continue to grow, should that make sense we'll have some, I think, tailwind to leverage with that conversion.

Operator

Your next question comes from the line of Matthew Howlett with B. Riley.

Matthew Philip Howlett
B. Riley Securities, Inc., Research Division

I'll jump in on the -- I heard the comments on Marucci, but that was really the outperformer at least relative to my numbers. I know there's some seasonality with the first half of the year. You mentioned with some success, there's some growth in some other product categories. What can you tell us what's going on there? I mean it looks like we had $230 million into the company is generating [$120] Plus of EBITDA. It looks like terrific. Just curious on what's going on there.

Patrick A. Maciariello
Partner & COO

Yes. So this is Pat. The -- as I mentioned, and I think I mentioned it in Q2, Q2 was a little bit light because we didn't have a product launch. And in Q3, we had what is kind of the big every other year launch at the Marucci brand, which is the CATX. And so that was -- that produced a very strong Q3. I wouldn't take kind of Q3 numbers and multiply it by 4 and say that's what the company is doing now.

We will have a good -- solid to good Q4. And there's -- and then beyond that, there's sort of momentum in sort of the other brand adjacencies that I mentioned. So in fastpitch softball and fielding gloves, which is a large market, and we're beginning to get some traction in.

So beyond that, there will be sort of incremental growth. I would say this business is characterized on the Marucci side by -- which is most of the business, by a big launch every 2 years, which will drive sort of again, Q3 and Q4. And then we'll have other smaller launches on the Victus side on -- and with other products.

Matthew Philip Howlett
B. Riley Securities, Inc., Research Division

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Earlier in the year, you mentioned some supply chain issues or getting the products to shelf. And that's cleared up in terms of what the regional...

Patrick A. Maciariello
Partner & COO

Yes. I mean you'll see that the margin growth for these -- sort of EBITDA growth did not keep up with the revenue growth, and a lot of that was driven by -- this was one of those companies that was most sort of heavily impacted by having to air ship a lot of products. And that is starting to clear up -- as Elias mentioned more broadly, but specifically to Marucci, that is starting to clear up. And we're starting to see margins return to sort of a more normal level.

Now there's some margin mix, right, as we sell Lizard Skins' bat grips and as we sell gloves, these may not have the exact same margins as aluminum bats or wood bats, but there will be mix, but the sort of the big supply chain costs are, knock on wood, getting behind us.

Matthew Philip Howlett
B. Riley Securities, Inc., Research Division

Great. And then maybe just help me understand this a little bit more. I mean one of the benefits of CODI's structure that the intercompany debt to eliminate, but it's just -- since you own the companies, you have the debt against them. Could you just go a little bit over, I mean that's floating rate debt, I mean, is it -- do I think a bit right where you're going to be able to take cash -- more cash out of the company? I know it's for tax purposes. But am I thinking about that the right way where you could maybe fund more working capital but not obviously doing anything to jeopardize the companies or pressure of the companies from a debt service coverage ratio. Just walk me through that interplay within your company debt, the cash flows that come from the companies clearly, they're better to be inside CODI than they are using third-party leveraged loans. Just go over that, your rising rates on the intercompany debt part.

Elias Joseph Sabo
Partner, CEO & Director

Sure. So Matt -- you want to do it?

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

Okay. I'll take Elias . So I would start off by saying at high level that in the end, whatever subsidiary earns in free cash flow, it will send to CODI. And we'll do that because all of the management teams, right, are equity owners of each individual -- each company's individual stock and they want to pay their debt back off as quickly as possible. So they're going to pay your interest back and principle and do so as much as possible.

Now in the case of rising rates, you're correct in that there will be more interest expense paid. But what that probably means is they'll just pay a little less principal back because the interest expense is a little higher, right? But in the end, that subsidiary will send whatever cash flow it can to CODI. I think the little benefit that we do get, though, is with some rising interest expense at the subsidiary level, which, as you said, is intercompany and gets eliminated, they're all C-corps and they, in theory, will have less pretax income and pay some less taxes there.

So in theory, a little less cash goes out of the system because of that and yet stays within CODI. So it is really tax strategy at the subsidiary level. You're correct it all floats -- it all does eliminate. But I think the key message here is in the end, every subsidiary will send as much cash as they can through weather interest expense or amortization of that interest or principal payments.

Matthew Philip Howlett
B. Riley Securities, Inc., Research Division

So if I hear you correctly, you're indifferent from the CODI perspective from shareholders of CODI -- shareholders are indifferent to how you get that cash. I mean all in all, obviously, it's nice to limit pay less

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in taxes, but in reality is you don't -- I mean you're not trying to take more money out of the company by raising higher interest expense internally.

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

No, that's correct. I mean there is an income stream to CODI, which is now reclassified as a C-corp. So in theory, we have higher interest income coming up to CODI, but our expenses at CODI more than offset that interest income. We actually operate on an annual basis and are well-positioned assuming we don't sell. So there's really not a whole heck of a lot of tax impact at CODI for this.

Certainly, our interest expense is rising. So that does add interest expense at CODI. So those are really the dynamics affecting us here with the rising rates.

Elias Joseph Sabo
Partner, CEO & Director

And Matt, just it's interesting and counterintuitive. Higher interest rates because we've locked in our debt on 70% whatever, 72% of it or something, is locked in. Because of that, higher interest rates likely are earnings accretive to CODI. And I know that's a kind of a strange concept to think about, but we only have 28% of our debt that actually has a higher interest expense out the door, but our companies have 100% of their debt owed to us with higher interest expense, which gives them a greater tax shield and therefore, has lower cash taxes.

So if you think about the 2 net items to CODI; one is, well, the companies are going to have less cash taxes that are going out the door. On the other side, CODI's got a little more interest expense because the debt that we locked in at CODI, the amount of interest expense going out the door is less than the amount of tax savings that we end up achieving by having our companies pay us higher interest rates.

And again, I know that's counterintuitive. But our cash flow actually improves marginally and a rising interest rate, our cash earnings improved marginally because of that, which is, I know, a little bit counterintuitive, but it also has to do with us having most of our debt fixed and our companies having their debt be variable.

Matthew Philip Howlett
B. Riley Securities, Inc., Research Division

Yes, sort of an embedded inflation that I didn't really see it first and now see it. And of course, since you own the company, I mean there's no in terms of debt service coverage is never -- they're not obviously worried about anything, you've seen in the broader leverage loan market in terms of interest coverage like that. It's not an issue with your company. So that's an interesting dynamic.

And I guess with that, I mean, was there any update to the working capital, the capital expenditures in Lugano and at 5.11, I know you've laid out some guidance, it was around [$70 million] last quarter. Just curious an update there, but Lugano looks like the more money you give it, the more money it makes. I mean, any update there?

Patrick A. Maciariello
Partner & COO

No. I mean it will be -- you've seen us -- as the company continues to grow, we'll continue to fund inventory and we monitor it, obviously, very closely as it's a large investment, but the company is proven to be good stewards, and a lot of the sort of ratios that we look for around inventory are improving. We're not -- at least not getting worse, so they're solid and stable. And as it relates to 5.11, I think we're about to open our 107th store. The stores proved to be a great driver of growth and profit, and we believe we'll continue to do that next year.

Operator

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

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Elias Joseph Sabo
Partner, CEO & Director

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. That concludes the call, operator.

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

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