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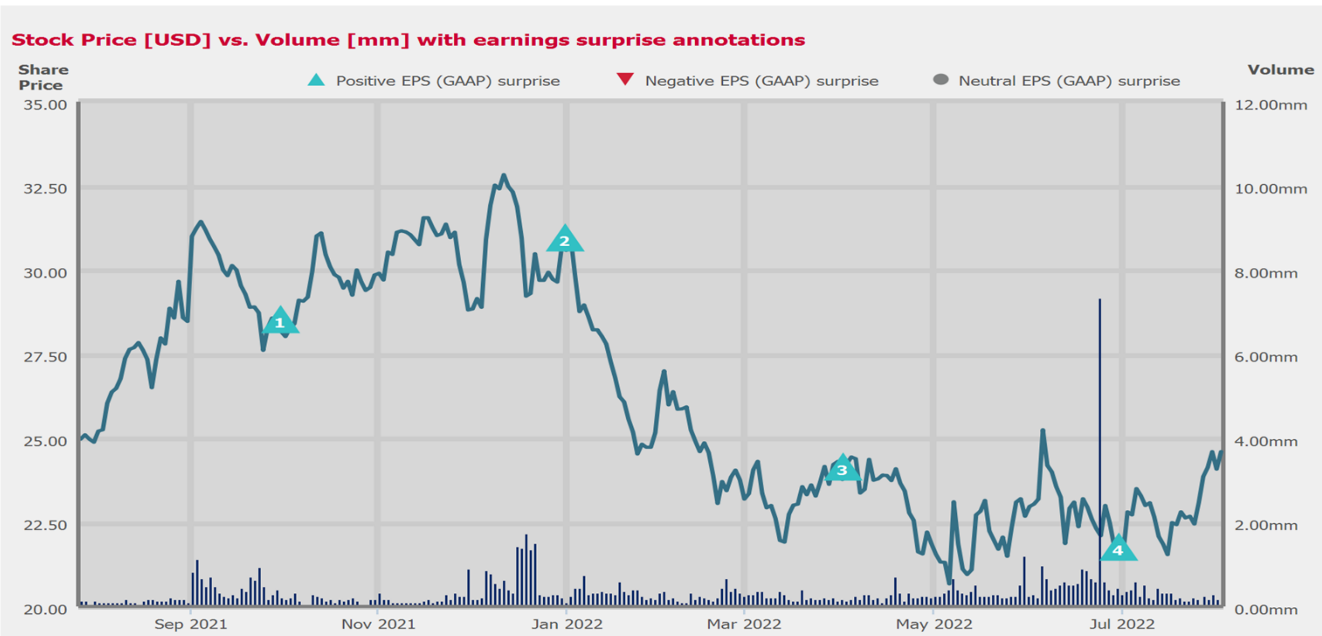
Market Intelligence

Compass Diversified NYSE:CODI
FQ2 2022 Earnings Call Transcripts
Wednesday, August 03, 2022 9:00 PM GMT
S&P Global Market Intelligence Estimates

	-FQ2 2022-			-FQ3 2022-	-FY 2022-	-FY 2023-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS (GAAP)	0.11	0.17	▲54.55	0.93	1.51	0.79
Revenue (mm)	502.15	515.60	▲2.68	530.41	2130.39	2304.70

Currency: USD
Consensus as of Jul-11-2022 3:18 PM 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	0.17	▲4 54.55 %

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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

Barry George Haimes
Sage Asset Management, LLC

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

Lawrence Scott Solow
CJS Securities, Inc.

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

Michael David Zabran
ROTH Capital Partners, LLC, Research Division

ATTENDEES

Cody Slach
Gateway Group, Inc.

Presentation

Operator

Good afternoon, and welcome to Compass Diversified Second 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 instructions 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 Second 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 Q2 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 non-GAAP financial measures discussed on this call including adjusted EBITDA and adjusted earnings and is also available at the Investor Relations section of the company's website.

Please note that references to EBITDA in 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 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 June 30, 2022, as well as in other SEC filings. In particular, the domestic and global economic environment is 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'd 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 second quarter 2022 conference call. I am pleased to report that we continued our strong momentum in the second quarter of the year as we recorded our sixth consecutive record quarter and our sixth straight quarter of double-digit increases in pro forma consolidated subsidiary adjusted EBITDA, once again, enabling us to raise our 2022 outlook. We're extremely pleased with these results particularly given the macroeconomic headwinds that all companies are facing today.

We again need to acknowledge the skill and agility of our management teams and employees. Each day, it seems they wake up to face a new issue stemming from inflation or a new supply chain disruption. And each day, they put forth extraordinary effort and adjust. In our last several earnings calls, we discussed our strong execution against the tough macro environment, and this quarter was certainly no different. Though inflation may be just starting to crest and there has been some improvement in certain pain points of the supply chain, we remain guarded as inflation will likely remain at elevated levels for some time and slight improvements in the supply chain could reverse quickly.

During the quarter, we again delivered double-digit sales growth in both our branded consumer and niche industrial businesses. Our growth this quarter was led by BOA Technology and Lugano Diamonds, which each had excellent quarters. BOA produced record quarterly revenues and over $24 million of EBITDA, nearly reaching its record Q1 figure. We mentioned last quarter that one component of BOA's growth could be due to the elongation of the supply chain and that some demand could be the result of pull forward from future quarters. Though this dynamic did not impact the company's stellar performance in the second quarter, we do believe that BOA's growth rates will slow somewhat in the second half of the year from these torrid levels. It's our expectation, however, that the company will continue to show growth due to its exceptional technology, low penetration in existing markets and planned expansion into new markets.

We believe Lugano continues to offer its customers a better value proposition than other ultrahigh-end jewelers. In addition, the company has benefited from geographic expansion and CODI's continued inventory investments following our acquisition late last year. Due to these investments and the hard work of the Lugano team, EBITDA has grown by over 60% in the year-to-date period. Overall, we once again did an extraordinary job of growing while preserving margins. In fact, in the second quarter, our consolidated pro forma adjusted EBITDA margin actually expanded slightly versus the second quarter of 2021. Though we anticipate continued economic headwinds could impact our margin going forward, we believe our subsidiaries' strong competitive position and exceptional management will continue to allow us to outperform our competitors in this challenging environment.

Before I turn the call over to Pat, I want to address the closing of our PrimaLoft acquisition and the refinancing of our $1 billion bank facility, both of which occurred subsequent to Q2. We are excited about what PrimaLoft adds to the CODI family of companies. We believe the company possesses significant intellectual property, strong growth prospects and a world-class management team. Equally as important, though, their commitment to sustainability and their position as an enabler of growth of sustainable apparel is very much aligned with CODI's commitment to responsible growth and a good example of how we want to operate our business. As part of this transaction, Compass Group Management will waive approximately $5 million of management fees in the first year of ownership. Separately, our refinancing, which we completed simultaneously with the PrimaLoft transaction, both expanded CODI's capital base and increased our financial flexibility. This enabled a further reduction in our blended cost of capital, which we believe is a key to creating long-term shareholder value.

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

Patrick A. Maciariello
Partner & COO

Thanks, Elias. On a combined basis, revenue and pro forma subsidiary adjusted EBITDA in both our branded consumer and niche industrial businesses grew meaningfully and continued to exceed our expectations. For the quarter, as Elias mentioned, EBITDA growth exceeded revenue growth as we were able to increase margins slightly. Our businesses continue to perform admirably throughout this unprecedented period. However, several of our companies who sell to retailers focused on mass channels did face pressure as consumers in that segment continue to be impacted most acutely by inflation. Nevertheless, our management teams continue to execute for their customers and employees, and we're able to drive considerable growth as a whole in this difficult environment.

Now on to our subsidiary results. I'll begin with our niche industrial business. For the year-to-date period, revenues increased by 16.8%, and adjusted EBITDA increased by 16.4% versus the year-to-date period of 2021. Arnold and Altor once again posted meaningful revenue and adjusted EBITDA growth driven by solid execution and stronger-than-expected demand. Arnold continues to benefit from investments made over the last several years in technology and infrastructure. Though the company will be comping against a very large defense-related order in the back half of this year, we are continuing to see strength in bookings and believe the company will have solid performance in the remainder of the year. Altor had solid growth, partially driven by its acquisition of Plymouth Foam in the fourth quarter of 2021. Though margins continue to be pressured by higher raw material costs at Altor, our expectations are that these margin levels should improve in the back half of the year.

Turning to our consumer businesses. For the year-to-date period, revenues increased by 13%, and pro forma adjusted EBITDA increased by 11.8% as compared to the same period in 2021. Demand for BOA's performance Fit System continue to exceed our expectations. The company's revenue increased by over 44% in the year-to-date period and have delivered just under $50 million of adjusted EBITDA in the first half of the year. As Elias mentioned, we believe BOA's growth will moderate in the back half of the year from these elevated levels, but we anticipate continued growth.

Lugano grew pro forma adjusted EBITDA by over 60% in the year-to-date period. We continue to see a strong correlation between inventory purchases and revenue. And we'll continue to support Lugano, and we look forward to the anticipated opening of 2 new salons this year in Houston and Newport Beach.

As mentioned last quarter, Marucci did not have a significant product launch in the second quarter of 2022 like it did in the corresponding quarter of 2021. As such, it experienced an expected decline in EBITDA. In Q3 of this year, however, Marucci is launching the highly anticipated CAT X line of bats. Though it's early, the company is seeing significant demand from both customers and its retail partners, and we're excited about the launch and the product.

Touching briefly on 5.11's performance to date. For the year-to-date period, revenues increased by 6.7%, and adjusted EBITDA was approximately flat versus the same period in 2021. We feel that this is a strong performance in the face of supply chain challenges and very difficult retail and wholesale environments. We believe the company's diverse channel mix as well as its strong brand, loyal consumer base and experienced management team is allowing it to continue to outperform its competitors.

Turning to Velocity. As mentioned in our prior earnings call, Q2 represented a very difficult comparable period for the company as retailers continue to replenish inventory levels in Q2 of 2021. We have seen just the opposite so far in 2022 as inventory levels in the mass channel are being reduced materially, sometimes regardless of product performance. Though we are confident in the team in place and the strategic steps they are taking to ensure future success, we anticipate the back half of the year will be somewhat challenging.

As a whole, we are very pleased with the performance of our businesses in the second quarter. We are optimistic about the remainder of the year. However, we remain very aware of the potential macroeconomic headwinds, and we'll adjust as needed.

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

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

Thank you, Pat. Before I get into our financial performance, I wanted to make a few comments on Advanced Circuits as well as our adjusted EBITDA calculation.

First, ACI. As you are aware, we announced the termination of the ACI sale last week. As a result, we expect to reclassify ACI from held for sale to continuing operations in our third quarter reporting. In addition, since its operating results will be reclassified to continuing operations, CODI will get the benefit of ACI's earnings contribution to our non-GAAP adjusted earnings metric from January 1, 2022. Therefore, our guidance, which I will discuss later in my remarks, has been updated to reflect ACI's full year of adjusted earnings contribution.

Now on to the adjusted EBITDA calculation. Effective this quarter, we are no longer adding back management fees to our adjusted EBITDA calculation. The impact of this change is a reduction in consolidated adjusted EBITDA by $14.9 million in the current quarter, which were the total management fees expense in the quarter. Of this $14.9 million, $1.5 million was incurred by our subsidiaries. Please note that this amount excludes ACI as it was a discontinued operations at June 30. As you'll hear in our consolidated subsidiary adjusted EBITDA guidance shortly, we have updated it to reflect this calculation change. In addition, our current year reporting periods and prior year reporting periods have been adjusted to reflect that management fees are no longer added back to adjusted EBITDA. And for clarification, this calculation change has no impact on our adjusted earnings calculation since all management fees are deducted.

Moving to our consolidated financial results for the quarter ended June 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, Q2 revenue was up 19% to $515.6 million compared to $431.5 million in the prior year period. This increase primarily reflects the company's acquisition of Lugano in September 2021 as well as the strong double-digit growth from BOA, Marucci, Arnold Magnetics and Altor Solutions. Consolidated net income for the quarter was $31 million, a significant increase compared to an $11.3 million loss in the prior year ago quarter. As a reminder, Q2 last year included a $33.3 million loss on debt extinguishment in connection with the redemption in April 2021 of our 8% senior notes due 2026.

As introduced earlier this year, we believe 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 was $39.3 million, up $11.4 million or 41% 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.

Turning to our balance sheet. As of June 30, 2022, we had approximately $102.7 million in cash, 0 drawn down on our revolver, and our leverage was just below 3x. Of note, the manager once again waived fees on cash balances held at CODI as of June 30.

Subsequent to the quarter, we purchased PrimaLoft for a $530 million enterprise value. We funded our portion of the purchase price of approximately $495 million with the proceeds from a new $400 million Term Loan A and a draw on our revolver. At the same time, we amended our senior secured credit facility to provide additional flexibility and extend the maturity of our revolver to coincide with the maturity of this new Term Loan A, which is July 2027. Pro forma for this transaction, our leverage would be approximately 4x, and our liquidity would be over $500 million.

As you can see, 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 second quarter of 2022, we used $1.8 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. Inventory levels at all our companies are a significant focus of our management teams in this difficult economic environment, and we are monitoring levels to ensure we meet consumer demand without a negative financial impact.

And finally, turning to capital expenditures. During the second quarter, we incurred $14 million of CapEx on our existing businesses compared to $8.8 million in the prior year period. The increase was primarily a result of the continued retail store expansion at our 5.11 subsidiary. For the full year of 2022, we anticipate total CapEx spend of between $55 million and $65 million. We have incurred $24.4 million year-to-date and the spend we expect in the second half of the year will be primarily at Lugano for its expanded headquarters and new retail salons and at 5.11 as we continue to increase its retail store count from its current 94 stores.

Now on to our adjusted EBITDA and adjusted earnings guidance. Despite our excellent performance in the second quarter, we remain in uncertain times driven by market volatility, the 2 quarters of GDP contraction that was recently reported, inflationary pressures impacting consumer behavior and labor market shortages amongst others. However, as a result of our company's strong performance in the second 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. Now there are a number of factors impacting this revised guidance, so I'd like to clearly discuss each.

As you're aware, our previous guidance range of 2022 full year consolidated subsidiary adjusted EBITDA was $410 million to $430 million. We are now including PrimaLoft into our guidance range by adding $30 million of adjusted EBITDA at the bottom end of the range and $35 million at the top end of the range. This would move our guidance range to $440 million to $465 million. As I mentioned earlier, we are no longer adding back management fees in the calculation of adjusted EBITDA. And therefore, our consolidated subsidiary adjusted EBITDA range would come down by roughly $8 million at the top and bottom end of the range. This would move our guidance range down to $432 million to $457 million. Finally, because of our strong Q2 performance, we are increasing this revised range to between $445 million to $470 million. At the midpoint, this is a $13 million raise due to strong Q2 performance and implies 10% year-over-year growth.

Next, I'd like to discuss adjusted earnings. As I mentioned earlier, because of the ACI sale termination, we are adding their full year 2022 results into our revised adjusted earnings guidance. In addition, we are raising our adjusted earnings guidance range because of our strong Q2 performance. Offsetting these increases is a slight reduction in our adjusted earnings guidance range for the acquisition of PrimaLoft as it generates its strongest earnings in Q1 and Q2 given seasonality of ordering for the outerwear industry. As a result of these items, our revised full year adjusted earnings guidance range will move from our previous range of $120 million to $135 million, upwards to $130 million to $145 million. The midpoint of our adjusted earnings range implies a 7% increase from prior year.

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 on our ESG-related activities in the quarter. M&A activity remains somewhat below historic levels, though it has picked up slightly in the second quarter. Potential sellers remain somewhat hesitant to begin processes given the economic headwinds and the macro backdrop. We anticipate activity continuing to increase modestly in the back half of the year if these headwinds start to moderate.

On the ESG front, we have had a productive quarter developing and implementing our mission, vision and values in an effort to strengthen our corporate governing purpose. It is our goal to continue to build and strengthen our culture of trust, transparency and accountability necessary to deliver long-term results. Our MVV process has enabled the creation of a clear pathway for the growth of our ESG framework, which has been strategically developed to deliver an environmental and social focus areas underpinned by good governance. We expect to have the Compass ESG framework formally approved by the CODI Board of Directors in the next quarterly Board meeting, and it will be publicly shared upon Board approval.

In addition, we are developing a set of core metrics and minimum standards to be tracked by each CODI company to enable consistent subsidiary measuring and reporting to enable us to develop accurate metrics for continual improvement. Our longer-term goal is to be able to integrate impact reporting into our public disclosures.

Lastly, we are continuing to develop policies and programs that create an inclusive and healthy working environment that inspires people to do their best. Our focus towards diversity of people and thought has introduced new perspectives, skills and approaches to problem solving that enhances our strategic and operating capabilities. We believe that this focus is an indicator of a commitment to building a high-performing, purpose-driven workforce and an inclusive culture. In this last quarter, 50% of our new hires at Compass Group Management have come from diverse backgrounds, and we recently added one new female Board member as we're pleased to announce the appointment of Teri Shaffer to our Board of Directors on July 2.

In conclusion, it was a great quarter for CODI. Relative to our expectations, our performance was once again outstanding. As gross domestic product shrank for the second consecutive quarter, we once again grew revenue and adjusted EBITDA by double digits. Our management teams and employees continue to put forth incredible effort, and I'd like to give thanks and recognition to all of them.
With that, operator, please open up the lines for Q&A.

Question and Answer

Operator

[Operator Instructions] Your first question comes from Cris Kennedy, William Blair.

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

Elias, you guys have been acquiring faster-growing businesses over the last couple of years. Can you just talk about the long-term growth profile of Compass today versus maybe 2 or 3 years ago?

Elias Joseph Sabo
Partner, CEO & Director

Sure, Cris. Thank you for the question. We have -- if you look back over the last few years and if I go back to pre the pandemic in 2019, if you remember, we sold a couple of businesses which were -- one of which was relatively slower growing and -- Clean Earth, very good business but kind of grew at GDP. And then in 2021, we sold another business, Liberty Safe, which was also a relatively slow growth business.

And so through the sale of those businesses and then the acquisition of BOA, Marucci, Lugano and now PrimaLoft, what we've seen is the portfolio composition has changed really dramatic with respect to our core growth rate. And I would say, before, we used to talk in the context of we are a slightly stronger than GDP growth company. Now we believe we're kind of a high single-digit type growth company, potentially a low double-digit growth company at the adjusted EBITDA line. And that's a subsidiary adjusted EBITDA pre the deduction of management fees.

Just to be clear here, Cris, and as we've defined new adjusted earnings metrics, we do get quite a bit of leverage on growth. Our management fees, as you know, principally don't grow unless we do acquisitions. So if we think adjusted EBITDA at the subsidiary level is growing kind of high single digits, there's a leveraging up of kind of the corporate EBITDA, which deducts management fees because that expense stays flat. And then as you further know, we locked in all of our debt prior to the increase in debt rates that happened at the beginning of this year. And $1.3 billion of our debt in the bond market is locked in at 5% and 5.5%, respectively, and now we have just a small amount. For PrimaLoft, we have $400 million term loan that's floating rate, but the spreads are relatively low on that.

And so if you think about just the amount of fixed expenses that we come underneath, including interest and management fees, we think that high single-digit growth rate of subsidiary adjusted EBITDA should leverage into strong kind of growth rates and adjusted earnings just based on how the math works. But I think largely, one of the things that we're demonstrating right now and may have been not as apparent to the market is that the core growth rate of this company has absolutely accelerated as we've engineered this portfolio transition by buying faster growth businesses and shedding some of our slower-growth businesses.

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

Got it. Great explanation. And then just one last one on the health of your consumer. I know CODI generally has higher end consumers, but just there's a lot of uncertainty out there. But just talk about the health of your consumer and your ability to pass through inflationary pressures on your consumer.

Elias Joseph Sabo
Partner, CEO & Director

Sure. So I would say just -- and I'll give kind of an overall macro view of what we're seeing, and frankly, our guidance is very much tempered based on some of the headlines and this change in Fed posture we really haven't seen in a very long time of Federal Reserve that has been as aggressive as it is and is projecting to be kind of further aggressive going forward. And so the overall uncertainty, Cris, just that exists in the marketplace right now has caused us to really temper expectations. Now all that being said, we generally see demand as staying strong. I would have said a quarter ago we see demand really more at a torrid level, and so I think it's kind of downshifted a little bit. But part of what we think is happening is there's a more normalization of inventories throughout the supply chain right now. So some of the initial orders that are coming in can be reflective of that.

And so as we've all heard, customers -- or companies have really expanded their inventory positions, and there was an elongation of the supply chain. I would say broadly, we're now seeing companies start to shrink their inventory position. And it really doesn't matter whether you're at the low end, the middle end or the high end of the marketplace. We're just seeing that broadly, and that's starting to bring down slightly what the new order flow coming in. So we do think there will be some inventory adjustments that generally weighs a little bit on what our revenue growth looks like and otherwise would be without that normalization.

Now on the other side, I will say we're also starting to see some moderation in inflation in some of the other issues that our companies are dealing with. Supply chains are starting to loosen a little bit. We're seeing flow of goods get better. We're seeing employee availability in certain job classifications and in certain regions get much better. And I think those are all going to proceed either a topping of inflation and even a kind of lowering of inflation later in the year. So although we're seeing demand start to moderate slightly, we're also seeing kind of the impact on our cost of goods start to moderate as well. And with our customers, we've been able to push through and continue to push through price increases that will protect margins. And as you saw in the second quarter, we were actually able to expand margins year-over-year due to the -- what we view as very good inelasticity of demand for the products that we generally sell.

Now when you think about kind of the portfolio, we skew towards the middle and higher end buyer in our portfolio. And if you just had to take a real kind of guesstimate here, I would say less than 10% of our adjusted earnings is driven by mass channel distribution that we have. And that's obviously, in today's environment, very good for us because we are seeing the mass channel, unlike the rest of the business, have end market demand that is really declining rapidly. I think that customer, in particular, is getting hit hardest from food and energy inflation. And therefore, discretionary items aren't being purchased as much.

So if you think about our guidance, it really includes that component of our portfolio weakening quite significantly. But outside of that, we see end demand staying pretty strong. And our greatest evidence of end demand really comes from 2 companies: Lugano, which continues to put up record quarters and continues even into kind of the beginning of the third quarter to have extraordinary growth that we're experiencing; and 5.11 through the direct-to-consumer channel and we're seeing incredible growth, strong growth there, too. So I would say it doesn't feel like end market demand and consumer demand for us is weakening at all. There could be some inventory adjustments that cause growth rates to decline somewhat. But we feel generally pretty good but are cautious given just the general macroeconomic environment that we're operating in today.

Operator

The next question comes from Larry Solow of CJS Securities.

Lawrence Scott Solow
CJS Securities, Inc.

Just a couple of follow-ups to that, Elias, on the price increases, which I know a lot of your businesses certainly have pricing power as leaders. Has it been -- have you found it increasingly more difficult to continue to raise prices? Have you seen some pushback from customers or some elasticity as you continue to raise prices? I'm just trying to get a feel for that. And have you also -- are there other workarounds? Have you been able to maybe increase suppliers in some instances? Or I know you've been building inventory outside of Lugano, but in other places where you maybe normally don't hold as much inventory. So just trying to get some idea on some of the workarounds.

Patrick A. Maciariello

Partner & COO

Larry, this is Pat. I would say, holistically, what we're trying to do is provide value to our customers. And so product A may be -- with product line A, you may be able to raise prices a little bit more than product line B, right? We had sort of the, what I'll call, the hatchet raise. And now further raises are more scalpel, as you will, kind of looking at what products are really sort of underpriced relative to the value that they convey to the customers, right? We have a diverse group of suppliers that we've -- at each business that we're constantly looking for the best prices on.

And then as Elias mentioned, we are seeing certain sort of COGS-related items moderate a little. Freight costs are down. That was a big driver. I mean they're still significantly up from year ago levels, but freight costs are down. Gas energy is down. So we're seeing some of that, which is also -- we're just starting to maybe -- I think that's why Elias said -- used the term cresting. We're just kind of starting to see that cresting. So that's sort of where we are now in kind of a state of play. Does that make sense?

Lawrence Scott Solow
CJS Securities, Inc.

Yes. No, absolutely. Just specifically on Lugano, do they sort of benefit or maybe not really get impacted -- inflationary environments on diamonds. And I would also think the people that -- the audience that these are being sold to. Does this type of environment -- obviously, the performance there doesn't seem to be impacting them. But -- and it also seems like the more you invest in working capital, it seems like the more you can earn. So just trying to -- maybe that's not quite true. But -- so does the inflationary environment actually hurt Lugano or it maybe actually benefits them?

Patrick A. Maciariello
Partner & COO

I think if the benefits -- so a couple of things. First, as diamond prices go up, it's good to have a lot of diamonds, right? So that's number one. Second, I would say, it's probably -- I mean, I know all of us as we see inflation, we look to hard assets as stores of value, right? And their pieces are beautiful. They're pieces of art, but there's also sort of a very large hard asset sort of component of it. So in that way, I do believe there's strong demand, and we've seen it from competitors, kind of strong demand for all sort of -- not all, but for many sort of ultrahigh-end retailer of those, right? So it's kind of -- ultrahigh-end jewelers.

So it's kind of both pieces, if that makes sense, right? We don't mind it. And I'd just add that because of Lugano's business model that we've talked about, we think we're providing, again, more value to our customers than any of our competitors because of some of the ways that team there has been able to disintermediate and purchase.

Lawrence Scott Solow
CJS Securities, Inc.

Okay. No. Fair enough. And just lastly on 5.11, I think you guys mentioned revenue is up close to 7% year-to-date and EBITDA sort of flat. It's just more supply chain issues. Were those supply chain issues more front-end loaded? I thought that was -- a lot of that was in the beginning of the year, and hopefully some of that is waning for 5.11. And then on the other side of it, on the revenue side, I think you mentioned the direct-to-consumer side is still doing really well. How about the professional side? I would feel like that's -- it feels like more dollars are going into that these days than maybe a couple of years ago. But maybe [that's just perception], but any thoughts on that?

Patrick A. Maciariello
Partner & COO

So we are seeing the -- and I think we had stronger performance in Q2 than in Q1 at 5.11, right? And I think we touched on that last time that in March, we really saw kind of the really critical like not getting any inventory in issues sort of abate, right? But there's still a lot of acute issues. I mean you heard about the truckers strike in the L.A. and the Bay Area ports, right? Well, that cost us some revenue as we weren't able to get products shipped in, if that makes sense.

And then on professional side, our professional business is very strong, and we're seeing strong professional demand. And I think some of the sort of pullback that we witnessed post-pandemic in sort of people's appetite to support local and international professional market has mitigated, and they've realized that they need to catch up. And so we're seeing really good professional demand. Where we're seeing some weakness is in wholesale, which is a smaller component of our business. But if you remember, 5.11 does have some wholesale business, nonprofessional consumer wholesale business, which is facing the same sort of inventory...

Lawrence Scott Solow
CJS Securities, Inc.

That same mass retailer, yes. Yes.

Patrick A. Maciariello
Partner & COO

Yes, that's what you hear about it, right? And so there is some of that. And I'd say e-comm and DTC continues to be strong. I would say e-comm is not as -- is moderating a little bit from year ago levels, but I'd say it's still strong in putting up respectable numbers.

Operator

The next question comes from Matt Koranda of ROTH Capital.

Michael David Zabran
ROTH Capital Partners, LLC, Research Division

It's Mike Zabran on for Matt. Just in terms of 5.11, could you just comment on your comfortability with the current store count in relation to your initial rollout expectations? And then from there, has the ability to get inventory improved at all since last quarter? Or are we still experiencing some headwinds on that front?

Patrick A. Maciariello
Partner & COO

So I think we have 94 stores now. We will be opening a number of stores in the back half. I think that we said we were going to do 25 this year. I think we'll -- 20 to 25, 1 to 2 a month. I think the back half is more loaded than the front half. So look, I would be looking forward in the next several months to the press release of our 100th store. And again, those stores are continuing to perform well.

What we've seen -- and we have seen improvements in the receipts of inventory. But again, if you say it took 2 months to get from factory to 5.11 before, it's still -- we still are budgeting in sort of 3 or longer, right? It's just that, that elongation has happened, and our inventory has expanded sort of because of that, right? But yet that elongation has stayed constant or maybe improve slightly a day or 2 here or there, if that makes sense. We have not yet started to sort of reduce those levels and pull back on our order time and being able to order kind of closer to when we need it, if that makes sense, to shrink the inventory. We're not yet in that phase of the recovery, but we are able to manage our inventory better because that -- the elongation has stopped getting longer, if that makes sense.

Michael David Zabran
ROTH Capital Partners, LLC, Research Division

Right. Yes, absolutely. That's helpful. And for Marucci, could you just comment on the demand environment and help us understand what's really dragging our margins here?

Patrick A. Maciariello
Partner & COO

Yes. I mean a couple of things. First, Marucci, like everybody else and we touched on it, had some air shipments. And those air freight, as you know, get -- put in inventory and average out over time. We've seen that improve. We expect margins to improve significantly in Q3. And I would also say we feel demand is good. Preorders were good, and we feel demand is good for this sort of next line of bats and accessories and clubs. We're making inroads, and we think those roads will continue in Q3. Really, we are comping against a smaller launch last year. I believe it was the CAT9 Pastime that we didn't kind of replicate this year above the -- before the CAT X. So I'd expect a much better Q3 than Q2 at Marucci.

Michael David Zabran
ROTH Capital Partners, LLC, Research Division

Right. Okay. Got it. And last one for me. In terms of the M&A environment, maybe just speak to how comfortable we are pursuing any additional tuck-in opportunities in the near term and maybe just comment on private market multiples and how they've changed quarter-to-date.

Elias Joseph Sabo
Partner, CEO & Director

Yes. So as Ryan mentioned in his section, pro forma for the PrimaLoft acquisition, we're right around 4x leverage right now. It's well within sort of what is tolerable. And given kind of the growth of the portfolio, which I talked about earlier, and the increased core growth rate, the free cash flow that we generate, pre-making investments whether in growth CapEx or working capital, we're just in a very different position that allows us to have leverage that is above our target leverage. But to be clear, we're above our target leverage. As we've set out there, our target leverage is kind of 3 to 3.5x, and we sit 0.5 turn above the high end of our target. So our goal is to reduce our leverage back to within our target leverage. We feel that's a responsible amount of risk for us to have in our balance sheet for our shareholders, and it gives us the flexibility to run our business well.

Now I think there's a few ways to get there. Clearly, the ATM that you guys are all aware that we have in place allows us to get equity capital into deleverage. But on top of that, just growth in the portfolio increases the denominator, and that's deleveraging in and of itself and free cash flow will as well. So we think that those 3 components -- growth, cash flow from operations and ATM -- will get us back within sort of our leverage window in a relatively short period of time, and that's why we're comfortable at where we are right now. Now that being said, I think for small tuck-ins, we're still open for business. And generally, those are at more -- at better purchase price multiples. There are synergies that you can achieve, and they're generally smaller. So it's not going to push the needle on leverage all that much.

In terms of new platform acquisitions, we would need to bring in a substantial amount of equity capital in order to deleverage in order to pursue that, and that's just not something that we see a need for right now. Now clearly, we think the deleveraging that will happen given the ATM and the growth and the cash flow from operations, that's going to help put us in position to be able to look at platforms here in the near term. But I would say right now for tuck-in acquisitions, we're more open for business. We're a little bit more hesitant to add significant amount of leverage on our balance sheet given where we are relative to target.

In terms of your question on multiples, I would say it really is a bifurcated market, and that's typically what you see in times like this. What we're seeing right now are the A quality businesses, and I'll point to PrimaLoft as being the best business that we have seen come out here in 2022 -- at a minimum, '22, maybe even longer. But for a great business like that, there's lots of buyers who line up, and there's lots of capital that's available. And even though debt costs have increased, buyers are still willing to step up and pay large multiples for companies of this quality.

When you get into the lower-quality companies, we're just seeing those companies not transact. And so there's still expectations from sellers that the lower-quality companies are going to transact at levels where they would've a year or maybe pre-pandemic. And that's just not the case. And buyers generally are either willing or they get through diligence and they find reasons to kind of walk away.

So I think it's a very interesting market right now where you have either very high prices that are being paid for A quality businesses and then really not much that's happening outside of that. My sense is as markets open up again, we'll probably see multiples contract somewhat on some of the lower-quality businesses as there seems to have been a general repricing that's occurred in the -- at least in the public markets and in the debt markets for sure. So I think that will factor into the private markets, but I wouldn't expect for the high-quality A type businesses to see any material reduction in the valuation that's out there.

Operator

[Operator Instructions] The next question comes from Barry Haimes of Sage.

Barry George Haimes
Sage Asset Management, LLC

Great quarter once again. I have 2 questions. One, the financial market has only recently gotten a little better. But I'm just wondering, is there a set of circumstances where you would go back to the notion of a 5.11 IPO? And second question, I wonder if you could give us a little bit of an update on the health care initiative you guys have talked about. Have you built out the team? Are you starting to look at acquisitions yet? So just would love an update there.

Elias Joseph Sabo
Partner, CEO & Director

Sure, Barry. Thank you for the question. So first, with regards to 5.11, what we have said on numerous occasions and we'll continue to say, 5.11 is a great business. And this is one of the A-plus companies that we have in our portfolio. We're fortunate now to have a number of kind of A type businesses, 5.11 being kind of the one that we've had longest. We are happy holding 5.11 as long as necessary because it is going to provide great growth tailwinds for our shareholders and tremendous shareholder value creation, whether it's owned 100% or whatever. We have some minority interest there, or whether we have a component of that, that is publicly floated.

Now that being said, this company has done a lot in order to make itself a publicly viable company. From the creation of an extraordinary management team with great systems that they have in place and the underlying elements, whether it's working on ESG, whether it's working in a SOX-compliant environment, the company has the systems and the talent to be able to be a public company and it has the growth opportunity that public investors want. So it naturally should be a public company.

We do not view ourselves as needing to force it out into the public markets before they're accommodative. And so as markets become more constructive, as we see the consumer businesses, which still are trading relatively poorly especially if you look at a lot of the consumer IPOs that occurred late in '21 -- mid and late '21, they have performed incredibly poorly, that's just creating a really kind of negative backdrop still for consumer companies to go public. And I would say a company of this ilk, we don't feel a need to try to get it out there unless the markets are going to be very accommodative and reward our shareholders with the type of multiple that this company deserves.

And so are we always evaluating whether this company is ready to go back and become a public company? Absolutely. Do we think right now conditions, even though they've moderately ticked up, financial conditions in the last month or 2, do we think now is the time? Not yet. But as you know, financial markets can change rapidly. The tone of financial markets can change. If we see headline inflation start to really come down and the Federal Reserve change its policy stance and that creates the next kind of bull run in the market, then 5.11 will be ready. And at that point, we'll make a decision because we do view this eventually as becoming a public company. And so -- I'm sorry, your second question that you had asked?

Barry George Haimes
Sage Asset Management, LLC

Health care.

Elias Joseph Sabo
Partner, CEO & Director

On the health care initiative. Yes, we continue to advance along on health care. It's an important initiative I would say there's some candidates that we are in talks with. As you know, this is predicated on getting a leader who will be in and can direct that effort for us. And we're feeling more confident by year-end that we'll have some positive news to announce there.

Operator

The next question comes from Matthew Howlett of B. Riley.

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

Did you note any FX items on the earnings or the guidance here?

Patrick A. Maciariello
Partner & COO

Did you say FX? No. No FX, Matt.

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

Okay. Nothing with the strong dollar is not going to have any impact, or I mean, there's nothing to note there with the dollar strength at all?

Patrick A. Maciariello
Partner & COO

You don't adjust that out. You're not adjusting that out. No, we don't adjust that out. There's some impact that's pretty modest across the group of companies. So it's -- yes, so it's technically factored in as part of our guidance is the way to think about it.

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

Okay. Got you. Good. Okay. Good. Second question, on Sterno, there's a nice pickup there. Was it -- I know you had some -- on the 2 divisions, was it just the heating lamp with the sort of return to a conference schedule? Or was it the other division with the candles [and stuff]? Was there any sort of -- any reason for the pickup there?

Patrick A. Maciariello
Partner & COO

I would say the strength in Q2 was definitely driven by the Sterno side of the business, the core Sterno, kind of the party and the getting outdoors and the buffet sets as I think people are making up for weddings that didn't happen over the last couple of years and parties that didn't happen over the last couple of years.

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

Okay. Yes. I mean [indiscernible]. Any update on sort of the other side of the business? I know there was some, with Walmart, some of the inventory issues. Anything there?

Patrick A. Maciariello
Partner & COO

I mean I would say not performing as strong right now at this moment as the other side of the business. Performing fine, taking all necessary actions. And it kind of goes into some of the things we said before about kind of the more cost-conscious consumer being pinched a little bit by inflation.

Matthew Philip Howlett

B. Riley Securities, Inc., Research Division

Got you. Okay. And then real quickly on Lugano. I mean you said 2 more salons. I mean any sense as to how we think about modeling sales with these additional salons coming on?

Patrick A. Maciariello
Partner & COO

I -- let us think through that. I don't think we have a good answer for that right now. I mean -- and the short answer is the salons vary, right? Salons can vary materially in the sales level they have. So I think we're hesitant to put out sort of salon-level guidance.

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

Got you. Okay. Well, it certainly -- they certainly have a great big following. So it would be really interesting to -- could obviously have a really meaningful impact if these are successful. So we'll look for that. And then just remind us again, the Marucci, the new bats, interesting. How often do they introduce a new bat like that? [If you could just go over] sort of is it once a year or is it once every 2 years?

Patrick A. Maciariello
Partner & COO

Yes. So the big launches like the CAT X, CAT9, the big sort of Marucci-level launches tend to be once every 2 years. I would say there are sort of incremental launches or slightly smaller launches that we have in between. So Victus, our sister company, launched the NOX -- I think it was last year? Last year. Last year, we came out in the summer with the CAT9 Pastime, which was a different design sort of version of it. And then there's also right now markets that are launching. We launched a whole glove line, right? But it's the big bat launches that -- we've launched softball lines with the Echo. But it's the big sort of Marucci bat launches that provide the lumpiness. And for those, it's usually every 2 years.

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

Okay. Got you. Okay. So this is going to be a third quarter event, right, to sort of...

Patrick A. Maciariello
Partner & COO

Yes. We have a launch in the third quarter. It's going well. We should have a good quarter.

Operator

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

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.

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