24-Feb-2022

Compass Diversified Holdings, Inc. (CODI)

Q4 2021 Earnings Call

Copyright © 2001-2022 FactSet CallStreet, LLC

CORPORATE PARTICIPANTS

Matthew Berkowitz
Director, The IGB Group

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

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

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

OTHER PARTICIPANTS

Cristopher Kennedy
Analyst, William Blair & Co. LLC

MANAGEMENT DISCUSSION SECTION

Operator: Good afternoon, and welcome to Compass Diversified's Fourth Quarter 2021 Conference Call. Today's call is being recorded. All lines have been placed on mute. [Operator Instructions]

At this time, I would like to turn the conference over to Matt Berkowitz of The IGB Group for introductions and the reading of the Safe Harbor statement. Please go ahead, sir.

Matthew Berkowitz

Director, The IGB Group

Thank you, and welcome to Compass Diversified's fourth quarter 2021 conference call. Representing the company today are Elias Sabo, CODI's CEO; Ryan Faulkingham, CODI's CFO; and Pat Maciariello, COO of Compass Group Management.

Before we begin, I'd like to point out that the Q4 2021 press release, including the financial tables and non-GAAP financial measure reconciliation, are available at the Investor Relations section on the company's website at www.compassdiversified.com.

The company also filed its Form 10-K with the SEC today after the market closed, which includes reconciliations of non-GAAP financial measures discussed on this call, including adjusted EBITDA and cash available for distribution, and is also available at the Investor Relations section of the company's website.

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

Throughout this call, we will refer to Compass Diversified as CODI or the company. Now, allow me to read the following Safe Harbor statement. During this conference call, we may make certain forward-looking statements,

Copyright © 2001-2022 FactSet CallStreet, LLC

including statements with regard to the future performance of CODI and its subsidiaries and statements related to the impacts 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, since some of these factors are enumerated in the risk factor discussion in the Form 10-K as filed with the SEC for the quarter ended December 31, 2021 as well as in other SEC filings.

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

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

Elias J. Sabo

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

Good afternoon. Thank you all for your time and welcome to our fourth quarter earnings conference call. I want to start by recognizing that 2021 was an outstanding year for CODI. Our four consecutive quarters of record results have led to the best year in our history, and I couldn't be prouder. We continue to offer investors a unique opportunity to own a collection of diverse businesses across the consumer and industrial segments and soon potentially health care.

As we detailed at our Investor Day, we view health care as a natural next vertical to bring value to our shareholders. Ultimately, the quality, competitive position and extraordinary management teams of our current subsidiaries demonstrate how our strategy to patiently deploy capital continues to define our success. In 2021, we continued our efforts with a number of significant transactions.

At a platform level, we acquired Lugano Diamonds & Jewelry, which is a designer, manufacturer and marketer of ultra high-end, one-of-a-kind jewelry. Lugano has a disruptive business model that brings significant value to its customers and we believe, build on our transformation to accelerate the collective growth potential of CODI. Throughout the year, we also built on our long track record of being business builders. Our permanent capital advantage allows us to invest in the future of our subsidiaries. And this year, we consummated three add-on acquisitions; Ramco into Arnold Technologies; Lizard Skins into Marucci Sports and Plymouth Foam into Altor Solutions. We have now completed 31 add-on transactions for our subsidiary since our inception. All four of our acquisitions this year are meeting or exceeding our expectations and are on track to continue their growth trajectories.

In 2021, we also sold Liberty Safe and announced the divestiture of Advanced Circuits. At Liberty Safe, we had made transformative investments during our 11 years of ownership that resulted in a solid gain for our shareholders. While the Advanced Circuits transaction has not closed, it is important to highlight how our unique permanent capital structure allowed us the time and flexibility to take a long-term approach to value creation, investing in operations and capabilities of the company over our more than 15-year ownership period.

At the corporate level, we achieved a number of milestones that furthered our pursuit of a lower cost of capital. First and foremost, we converted from a pass-through entity to a C corporation for US federal income tax

Copyright © 2001-2022 FactSet CallStreet, LLC

purposes. This critical change will remove certain administrative requirements for shareholders, and we believe this will help expand our current shareholder base and will improve the likelihood of our stock's inclusion within indices.

In addition, it enabled us to implement an at-the-market stock issuance program, which is an important step to fund our business plan in a more efficient manner going forward. Beyond that, we also materially reduced our cost of capital by refinancing our 8% senior unsecured bond with $1 billion, 5.25% senior unsecured bond maturing in April 2029. And in November 2021, we achieved a further reduction in our capital cost with the placement of a $300 million, 5% senior unsecured bond maturing in January 2032. Each of these initiatives provided transformative tangible benefits in 2021 and ideally positioned us for further gains in 2022 and beyond as we patiently pursue value-additive transactions.

Although this was a record year for CODI, it is important to recognize the ongoing challenges from inflation and supply chain disruptions. For the decade leading up to 2021, the global economy produced modest inflationary pressures, oftentimes underrunning Central Bank expectations. However, we are now grappling with inflationary pressures building at an unprecedented rate stemming from the effects of previously unseen levels of supply chain disruptions and an incredibly tight labor market, with rapidly rising wages and very high levels of turnover.

As 2021 progressed, these challenges became more acute, and we expect to continue to experience these headwinds at least through the first quarter of 2022. Despite these challenges, our subsidiary companies produced remarkable results, a testament to the strength of our management teams and the quality of the companies we own. We have conveyed repeatedly that we look to acquire market share leading businesses with defensible competitive barriers, factors that allow for margins to be protected in differing economic environments.

I want to highlight that despite all the challenges from supply chain, labor availability and rising inflation, for calendar year 2021, we produced on a pro forma basis almost 20% subsidiary adjusted EBITDA margins, up 155 basis points over prior year.

In order to combat supply chain issues, we have chosen to significantly increase our inventory levels. However, a significant amount of our inventory at year-end remained in-transit and unavailable for delivery. We experienced a steady decline in warehouse deliveries throughout the fourth quarter with an offsetting increase in our in-transit inventory. This past January marked a low for deliveries to our warehouses. While February has proven to be marginally better, product availability is still the largest challenge our subsidiaries face. We expect supply chain issues to linger throughout the first half of 2022 and cost pressures to continue to rise. Where appropriate, we expect our subsidiaries will continue to raise prices in order to combat rapidly rising costs and protect margins.

Before turning to our financial results, I would like to discuss the initial public offering process for 5.11. As you are aware, in November of 2021, we announced the filing of a registration statement for the proposed public offering of 5.11's common stock. After being cleared by the Securities and Exchange Commission to proceed with the proposed offering, we monitored the markets carefully to find an opportune time to take the company public.

The markets in the fourth quarter of 2021 and thus far in 2022 have been unsupportive for new issuances. We have always viewed the public offering of 5.11 as a highly opportunistic event, and we do not feel compelled to complete a transaction while suboptimal market conditions persist. 5.11 has substantial runway to continue to grow at an accelerated rate, as it builds out its domestic consumer business. 5.11's domestic consumer business represents just over 50% of total sales. And with expected growth rates in the consumer business far exceeding that in our professional division, we would expect the business mix to continue to shift towards consumer going

Copyright © 2001-2022 FactSet CallStreet, LLC

forward. Given the continued market and economic uncertainty, we believe it is in the best interest of 5.11 and CODI shareholders to postpone the proposed initial public offering.

5.11 has an enthusiastic customer base and a strong position in the market, and we remain committed and excited for its continued growth in the meantime. We will continue to assess the capital markets, and when appropriate, we will consider leveraging the hard work already performed to position 5.11 to become a public company.

Now turning to our financial performance. I am pleased to report that our fourth quarter results were exceptional and once again exceeded our expectations. Throughout this presentation, when we discuss pro forma results, it will be as if we own BOA, Marucci and Lugano and divested Liberty from January 1, 2020.

On a pro forma basis, in the fourth quarter of 2021, consolidated revenue grew approximately 20% and adjusted EBITDA grew approximately 17% over the prior year's quarter. For the full year, consolidated revenue grew by 24% and adjusted EBITDA grew by 34%. And as a reminder, our subsidiary adjusted EBITDA grew by 1% in 2020 over 2019.

In order to eliminate the base year effect in 2020, where results were distorted due to the pandemic, we would like to highlight that our compounded annual growth rate of subsidiary adjusted EBITDA from 2019, the year before the pandemic started, has been approximately 16%. We believe this is a more reflective measure of our growth given the dynamic environment and the execution of our acquisition strategy that has resulted in a much faster core growth rate over the past two years.

Before I provide an update on our guidance, I want to reiterate that the macro environment remains uncertain. Many of the challenges we have dealt with throughout 2021 have continued into 2022. Demand continues to remain robust. However, the extensive supply-side challenges continue to increase. There are significant part shortages from our vendors, lack of available shipping capacity, issues with port congestion and a lack of trucking capacity. While our companies and their management teams are taking all appropriate actions to mitigate the impact of these challenges, supply chain constraints continue to put pressure on revenue growth while materially raising product availability costs. Notwithstanding these unique challenges, we expect to produce, for the full year of 2022, consolidated subsidiary adjusted EBITDA of between $400 million and $420 million. This represents pro forma adjusted EBITDA growth of approximately 1% to 6% from the prior year period.

It is important to note that adjusted EBITDA includes Advanced Circuits, notwithstanding its held-for-sale classification. In addition, we expect full year 2022 adjusted earnings of between $110 million and $125 million. Our 2022 adjusted earnings range does not include Advanced Circuits due to its held-for-sale classification.

We are guiding to a lower adjusted EBITDA growth rate than experienced over the past two years principally due to two factors. First, we expect our Velocity Outdoor business to revert to a more normalized level of demand. Velocity experienced a large spike in demand brought on by the pandemic and as a result, was unable to fully satisfy customer demand in the back half of 2020. This resulted in Velocity fulfilling stocking orders in the first quarter of 2021 that will not repeat in 2022.

Second, supply chain and inflation remain a concern. As a result, central banks around the world are becoming more restrictive in monetary policy, adding an element of risk to future demand. Consequently, we anticipate our adjusted EBITDA in the first quarter of 2022 to be flat to down a few percent as compared to the prior year.

Copyright © 2001-2022 FactSet CallStreet, LLC

We expect our growth rate in 2022 to be temporarily depressed and below our long-term core growth rate due to the factors highlighted. However, when we look at our growth over a three-year period, from 2019 and including our guidance for 2022, our compounded annual rate of growth of pro forma consolidated subsidiary adjusted EBITDA would be approximately 11% to 13%.

During 2021, we continued our efforts to refresh our board of directors. We were pleased to welcome Alex Bhathal to our board on January 1 of this year. Alex brings a wealth of experience related to smaller, privately held companies, including consumer product companies, and his knowledge has already been quite valuable to our board.

Our board is regularly reviewing its composition to ensure we have the right balance of skills and experience to oversee the CODI business. Accordingly, we will continue to refresh the board, ideally with diverse candidates as we round out our collective skill set and seek to enhance our board's effectiveness.

In addition to the board refresh process that we have undertaken, the board recently approved an amendment to our organizational document to declassify our board. This declassification will result in an annual election for all of our board members, starting with the May 2022 Annual Meeting. As a reminder, previously, our board was staggered, with each director serving three-year terms. Declassifying the board is an important governance enhancement for our shareholders and aligns with our philosophical view of accountability.

Before I finish discussing our board, I want to take a moment to acknowledge the passing of Gene Ewing. Gene was an initial director of Compass when we became a public company in 2006. Over the years, Gene added immeasurable value to our board. Gene was a tremendous colleague and a personal friend for many years. We will sorely miss him.

Lastly, before turning the call over to Pat to discuss our subsidiary results, we're excited to have Zoe Koskinas join us as our new Head of ESG. Zoe brings a wealth of experience to our ESG initiatives, and we will report on some of the work she will undertake in the coming year and beyond.

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

Patrick A. Maciariello

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

Thanks, Elias. Before I begin on our subsidiary results, I want to talk generally about the industry trends we saw throughout the quarter. Revenue and EBITDA in our branded consumer businesses as a whole exceeded our expectations. Even as in many cases, our businesses cannot fully meet the demand for their products due to supply chain constraints.

Similarly, our niche industrial businesses also performed above expectations as a group. In certain instances, margins and EBITDA performance while strong, lagged revenue growth. These lags were driven predominantly by the extraordinary measures taken by our companies to meet or exceed the expectations of their end customers. In Q4, this pursuit often required increased air freight and expedited shipping, among other increased costs. In each case, our management teams performed admirably.

Now on to our subsidiary results. I'll begin with our niche industrial businesses. For the fourth quarter of 2021, revenues increased by 15.8% and EBITDA increased by 15.3% versus the fourth quarter of 2020. For the year, revenues increased by 14.4% and EBITDA increased by 11% versus 2020.

Copyright © 2001-2022 FactSet CallStreet, LLC

For the full year 2021, revenue at Advanced Circuits increased 2.7% versus 2020. The company experienced a strong fourth quarter as backlog caused by supply delays in Q3 mitigated the modest December slowdown typically experienced by the company. The management team at Advanced Circuits worked effectively in 2021 to limit the impact of pandemic-related supply chain issues and backlog across the company's three-facilities remained strong. We believe the closing of the Advanced Circuits transaction remains on track and is expected to occur early in the second quarter of this year.

Arnold Magnetics revenue increased by 41.4% and EBITDA more than doubled to $21.6 million for the full year of 2021. Notably, we acquired Ramco on March 1, 2021, and their performance is included in our financials since that time.

The majority of increases in revenue, however, were driven by organic growth following 2020's COVID-depressed demand levels across aerospace-related, industrial and automotive customers. We expect the company to continue to make progress in 2022 and are encouraged by the projects coming out of its new technology center. Performance in 2022, however, is likely to be muted versus 2021's growth levels as Arnold shipped the majority of several large defense orders in 2021.

Outdoor Solutions revenue grew by 38.6% and EBITDA grew by 8% for the full year 2021. Though the company acquired Plymouth Foam at the beginning of Q4, the comparable period includes the sales of a significant amount of COVID-related vaccine coolers that did not repeat in 2021. Margins continued to be under pressure in the fourth quarter due to significant increases in the company's core raw material. And though we expect the company to show material growth in 2022 driven by add-on acquisitions completed in the last 12 months, we do expect margin volatility to remain.

The Sterno Group's revenue increased by 1.4% and EBITDA declined by 8%, respectively, for the full year of 2021. This year, as we have noted, Sterno experienced over $5 million of restructuring expenses, as they exited a lower-margin business. These costs will not repeat in 2022, and no volatility in food service-related sales will remain due to the ebbs and flows of the reopening process. We expect the company to return to EBITDA growth in 2022.

Now turning to our branded consumer businesses, which, as a group, experienced an exceptional year in 2021. Our results are presented as if we owned Marucci, BOA and Lugano from January 1, 2020. In the fourth quarter, these businesses grew revenue and EBITDA by 22.7% and 18.5%, respectively. For the year, each of our branded consumer businesses showed meaningful growth. And as a group, revenues increased by 30.7% and EBITDA increased by 49.3% in each case versus 2020.

For the full year of 2021, BOA increased revenue by 55.3% and EBITDA increased by 77.1% versus 2020 to $60.5 million, exceeding our expectations. BOA continued to experience strong demand across most of its categories, led by athletic, outdoor and snow customers. In 2021, BOA continued to make gains in [indiscernible] (21:31), increasing the number of models that they are partnering [ph] on broadly (21:34).

We are also excited to announce that we expect BOA will be entering the alpine skiing category in the fall of 2023 selling season. BOA is partnering with several of the industry's leading brands and innovative products. Though some portion of BOA's exceptional growth stems from partners ordering ahead due to supply chain constraints, we believe the company is well positioned to show solid gains in 2022. We remain excited about BOA's future and continue to be impressed by the company's management team.

Copyright © 2001-2022 FactSet CallStreet, LLC

Ergobaby's full year 2021 revenue increased by 25.3% compared to 2020 and EBITDA increased by 26.1% to $19.7 million. The company experienced a strong fourth quarter as it fulfilled third quarter distributor orders that were delayed due to COVID restrictions at a large Southeast Asian manufacturing partner earlier in the year. Though we expect Ergobaby to have some volatility in its 2022 financial performance driven by supply chain tightness, lumpiness in the comparable 2021 period and a new product introduction calendar that is more back-half weighted than typical, we believe Ergobaby is still well positioned to have another solid year.

Lugano continued its strong performance since our acquisition in early September of 2021. In 2021, full year revenue increased by over 86% versus 2020. Full year 2021 EBITDA increased by over $20 million to $41.4 million as the company benefited from growth in recently opened salons in new geographies.

As discussed, given Lugano's disruptive business model, this growth requires investment in inventory, and we continue to support Lugano in the fourth quarter. We also made several important hires in the fourth quarter and early in Q1 2022 to build the infrastructure required for growth. We remain excited by Lugano's prospects in 2022 and beyond.

For the full year 2021, Marucci grew revenue by 79.2% and EBITDA grew by over 112%. Marucci grew revenue significantly in the fourth quarter as they continued to be granted additional shelf space at several key retail customers and achieved growth both in bat and non-bat categories. Margins were impacted by supply chain issues in the fourth quarter as the company remained relentlessly focused on meeting the needs of their retail partners. The company is very well positioned to have a strong 2022. Marucci's recent acquisition Lizard Skins performed above expectations in the quarter and we remain excited about its prospects.

Velocity Outdoor's 2021 full year revenue increased by over 25% compared to the prior year. EBITDA increased significantly, up 30% to $51.4 million. However, the company's performance declined slightly in Q4 as demand in its crossbow division outpaced supply due to difficulties in receiving certain key components.

In addition, retail demand in the company's air gun division has experienced some modest declines from pandemic peaks in Q4 2020 and Q1 2021. While inventory at retail has returned to normal pre-pandemic levels, we note that point-of-sales data indicates materially stronger demand than pre-pandemic levels. Early indications in 2022 appear to point to a solid year in the company's crossbow division. However, performance in air gun is expected to be between that, pre-pandemic and pandemic levels.

Finally, 5.11's full year EBITDA increased by 19.1% versus 2020 and full year revenue grew by 10.9% over the same period. Though growth remained solid in the quarter and total direct-to-consumer comps remained materially positive, 5.11 faced headwinds due to – faced headwinds to e-commerce sales growth due to significantly lower in-stock rates as a result of port congestion and extended delivery times from Asian factories. The 5.11 team has been working diligently to mitigate the impacts of the supply chain disruption. Due to their recent efforts, we believe that January represented a low point for receipts, and thus far in February, we have seen meaningful improvement. Combined receipts in January and early February indicate that 5.11's financial performance will be below our prior expectations for the first quarter. However, demand for the brand remains strong, and we believe the company is well positioned to show solid growth in 2022.

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

Ryan J. Faulkingham

Chief Financial Officer, Excecutive Vice President & Member-Investment Committee, Compass Diversified Holdings, Inc.

Copyright © 2001-2022 FactSet CallStreet, LLC

Thank you, Pat. Moving to our consolidated financial results for the quarter ended December 31, 2021, I will limit my comments largely to the overall results for CODI since the individual subsidiary results are detailed in our Form 10-K that was filed with the SEC earlier today.

As a reminder, as a result of the sale of Liberty Safe during the third quarter, our historical Liberty results have been reclassified as discontinued operations in our financial statements. In addition, Advanced Circuits is being treated in our financial statements as held-for-sale given the potential sale expected early in the second quarter of 2022. As a result, Advanced Circuits' assets and liabilities have been reclassified on the balance sheet to held-for-sale, and its results of operations and cash flows have been reclassified to discontinued operations in the current quarter and all prior periods.

On a consolidated basis, revenue for the quarter ended December 31, 2021 was $536.6 million, up 27.3%, compared to $421.6 million for the prior year period. This year-over-year increase primarily reflects our acquisition of Lugano during the third quarter of 2021. In addition, we had strong sales growth at our branded consumer subsidiaries and our niche industrial businesses on a combined basis.

Consolidated net income for the quarter ended December 31, 2021 was $25.9 million, compared to $8.8 million in the prior year. The increase in net income was primarily due to an income tax benefit recorded at corporate associated with Advanced Circuits' held-for-sale accounting, offset by an increase in interest expense.

We are introducing adjusted earnings as a new non-GAAP financial measure this quarter. This new metric will allow investors to assess our operating performance in a more meaningful and transparent way. To provide this transparency, we have provided reconciliations from net income as well as reconciliations to adjusted EBITDA in our Q4 earnings press release.

Adjusted earnings for the quarter ended December 31, 2021 was $32.5 million, up $9.8 million, or 43% from the prior year quarter. Our adjusted earnings that we generated during the quarter was above our expectations primarily due to the outstanding performance at our most recent acquisitions, Lugano, BOA and Marucci, as well as continued strong performance at our other consumer businesses and improved performance at our industrial businesses.

Cash flow available for distribution and reinvestment, or CAD, for the quarter ended December 31, 2021 was $42.1 million, up 17% from last year's quarter. As we had mentioned previously at our Investor Day, we will no longer provide the CAD metric going forward, as we believe adjusted earnings is a more appropriate representation of our results moving forward.

Turning to our balance sheet. As of December 31, 2021, we had approximately $157.1 million in cash, approximately $600 million available on our revolver, and our leverage was 2.96x. We have substantial liquidity, and as previously communicated, we have the ability to upsize our revolver capacity by an additional $250 million.

As Elias mentioned earlier, we issued in November a $300 million senior unsecured bond at 5% due 2032. With this liquidity in capital, we stand ready and able 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. Of note, during the quarter, given the sizable cash balance at December 31, we waived management fees on cash balances held at CODI.

Turning now to cash flow provided by operations. During the fourth quarter of 2021, we used $13.1 million of cash flow from operations, primarily a result of working capital use in the fourth quarter of $63.9 million. A substantial

Copyright © 2001-2022 FactSet CallStreet, LLC

portion of this working capital spend was at Lugano to support inventory build as we are seeing a direct comparison to inventory on hand and sales. In addition, we strategically increased inventory levels across many of our consumer companies to support near-term demand, which in turn should produce strong cash conversion in the first half of 2022.

And finally, turning to capital expenditures. During the fourth quarter of 2021, we incurred $12.5 million of capital expenditures of our existing businesses compared to 10-point -- compared to $10 million in the prior year period. The increase was primarily a result of the need for increased spend at many of our subsidiaries to keep up with elevated demand levels.

For full year of 2022, we anticipate total capital expenditure spend of between $70 million and $80 million. This is a substantial increase from 2021. However, we believe these capital expenditures will have short payback periods and provide strong returns on invested capital. The 2022 capital expenditure spend will primarily be at Lugano for new retail salons and at 5.11 as we continue to increase its retail store count from its current 87 stores.

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

Elias J. Sabo

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

Thank you, Ryan. I would like to close by briefly discussing our go-forward growth strategy. CODI's permanent capital structure offers shareholders a unique opportunity. We are able to drive value at every stage of our investments while leveraging our sector expertise to build businesses for the long term. We pride ourselves on being business builders, not asset traders, true partners to our subsidiaries as we bring the financial flexibility and scale of our strong balance sheet to the table. This advantage enables us to invest in the future of our subsidiaries regardless of the environment.

One recent example is at Marucci, where the team chose to air freight product to its retail partners that were offering additional shelf space in the store. Although this decision temporarily depressed margins in the fourth quarter, we believe that this investment will pay dividends through increased revenue opportunities going forward.

At the end of the day, this is the core pillar of our approach to sustainable investing, being able to identify platform subsidiary acquisitions that will benefit from our ability to invest in them through the cycle and opportunistically divest such subsidiaries to promote their or our long-term growth strategy.

Furthermore, we continue to take the necessary steps at a corporate level to lower our cost of capital and strengthen our capital structure, making us even more competitive. This is how we turn our [indiscernible] (33:10) capital advantage into long-term shareholder value.

As we enter 2022, market conditions are changing rapidly. The Federal Reserve has indicated that monetary accommodation will be reduced and interest rates are expected to increase materially. The stock market has experienced an increase in volatility, and stock prices have fallen. That being the case, I would like to point out that private market valuations move more slowly and methodically. There remains an abundance of equity and debt available to pursue M&A activity, and asset prices remain elevated.

We expect these conditions to remain in effect for the foreseeable future. CODI remains well positioned to succeed in these market conditions as evidenced by our successful series of transactions over the past few years.

Copyright © 2001-2022 FactSet CallStreet, LLC

Additionally, the dramatic reduction in our cost of capital over the past few years allows us to be selectively aggressive on acquisition opportunities that we believe will ultimately enhance shareholder returns. Going forward, we will continue to invest in and enhance our subsidiary companies' competitive positioning, which includes supporting them as they build and grow their digital transformation strategies. Our permanent capital structure and differentiated strategy has set us apart for more than 16 years, and it remains consistent.

In 2022, we remain intensely focused on executing our proven and disciplined acquisition strategy, improving the operating performance of our companies, enhancing our commitment to ESG initiatives at CODI and across our subsidiaries and creating long-term shareholder value.

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

QUESTION AND ANSWER SECTION

Operator: Thank you very much, Elias [Operator Instructions] And our first question is from Cris Kennedy from William Blair. Cris your line is now open, if you'd like to proceed with your question.

Cristopher Kennedy
Analyst, William Blair & Co. LLC

Q

Hey, guys. Thanks for taking the question. Elias, you mentioned that just wanted to dive a little bit more into kind of the updated pipeline looking into 2022, more platform deals or add-ons. What are you seeing out there in the market?

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

A

Yeah, Cris. Good afternoon, and thanks for being on our call. It's the market is really fluid right now. I would say we, you know, we're hearing about a number of transactions that were likely to come to market in early 2022. And, we were prepared for, I would say, a larger than usual number of platform acquisitions, to be looking at.

Now, as we're all aware market conditions are really fluid right now. So, we can look at what's happening in the debt and equity markets, which are less than accommodative obviously to M&A, but also just what's happening to operational performance across most companies with kind of the supply chain, the number of factors that we're dealing with, companies throughout the country are dealing with the same problem.

So, I would say, we're seeing some of the platform opportunities that we expected to come in, we put on hold right now. I would anticipate that the beginning part of the year is going to be muted in terms of new platforms. I do, however, think there are a number of companies that are ready to come to market and will come to market, but it's likely to be later in the year.

In terms of add-ons, we're always looking for add-ons. We had a good successful year last year completing three. We think there's a number of opportunities within our portfolio companies right now to complete some small add-on acquisitions. So we continue to stay focused. But as you know, Cris, it's hard to give to a direct answer on whether it will be platform or add-ons. We're always out and our teams are constantly pounding the pavement looking for opportunities. But I would say, I would be surprised if there's platform acquisition that we consummate here early in 2022 just given the backdrop of market conditions.

Copyright © 2001-2022 FactSet CallStreet, LLC

Cristopher Kennedy
Analyst, William Blair & Co. LLC

Q

Understood. Thank you. And then just one follow up. If you could just give us a little bit more clarity on the whole supply chain issue that you guys are having and then your ability to pass on higher prices to consumers, [ph] there will be any (37:52) elasticity of demand if you could? Thanks a lot, guys.

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

A

Sure. So supply chain has been a major problem. You hear about – we talk about inflation, supply chain and labor. If I were ranking them in terms of problems, supply chain would probably be number one, two and three, and then everything else would start beyond that. It is very difficult to quantify when you will get product, where even if product gets unloaded off of container ships, it sits at ports for extended times, there's limited trucking capacity that's out there. And as you guys can appreciate, we are trying to anticipate product coming in. If it doesn't come in, we have labor in our warehouses, and it becomes incredibly inefficient.

So, the challenges are as bad as we've ever seen. We saw January probably be the low point in terms of supply chain across the entire portfolio. The issue is raising prices, which we are doing, by the way, doesn't really help with that. If we have just unavailable product to sell because it's in-transit rather than in our warehouse, we just can't create revenue from that, but we do have some of the expenses for the expected shipping, either incoming or outgoing of that product. So it's been a real challenge, Cris. And I would say, we hope that it's going to get better, but it's not something that's within our control. We just need to see some of the surge in product that's coming through the ports, the reduced shipping capacity. We need to see some relief there. I will tell you that February has been a little bit better than January, but it's nowhere near normal.

Now our teams are doing an extraordinary job of trying to compensate for it. Frankly, in a really low carrying cost environment, like we're in right now, and when we place the $1.3 billion of bonds that we did last year at really attractive rates in the kind of low 5% context, that gave us the ability to add some inventory at a relatively low cost. And one way to get through these supply chain challenges is to increase the inventory levels that we have. Now, eventually that inventory will land in our warehouses, and we'll be able to make up a lot of the shipping that we're not getting right now in January and February as the year unfolds. So we have taken the approach that we will soften the supply chain impact with increased inventory investment. And Ryan alluded to the fourth quarter, how we did that. As that comes in our warehouses, I think that's going to help.

In terms of the question on pricing and elasticity of demand, this is one of the things that we've tried to highlight for years. Our companies that we own are great market share leaders. Our consumer brands are authentic, aspirational brands. That creates a lot of pricing power. And when we're in a rising inflationary environment like we're in today, companies of that ilk are going to have the best pricing power of any companies. Look, it's evidenced in our results last year. To be able, despite all of those challenges, to engineer 155 basis point margin improvement, I think that speaks to the quality of the positioning of our companies.

Now in some cases, we're playing catch-up and expenses are rising. We don't have the ability to pass through costs quick enough to be able to fully protect our margins. That's what we would expect to happen here in the first quarter, probably realistically in the first half. But because our companies have such pricing power in the marketplaces that they operate, we anticipate that to be a temporary phenomenon. And frankly, that will provide a tailwind at some point as costs start to level out and as our price increases continue to go in. And we would expect to capture any lost margin that we may have in the first half when we lap that in next year. So it is a temporary challenge. We are raising prices. So far, we're seeing the results. manifest pretty well for us, at least in

Copyright © 2001-2022 FactSet CallStreet, LLC

2021. But we anticipate some pretty stiff headwinds as problems have just gotten much more acute here as the year came to an end.

Cristopher Kennedy
Analyst, William Blair & Co. LLC

Q

Right. Thanks a lot, guys.

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

A

Thank you, Cris.

Operator: Thanks for your question, Cris. [Operator Instructions] And it appears we have no questions being registered at this time. So I hand back to Elias for any further remarks.

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

Thank you, operator. As always, I'd like to thank everyone again for joining us on today's call and for your continued interest in CODI. Thank you for your continued support. That concludes our call.

Operator: Thank you to everyone who has joined us today. This concludes the conference call and you may now disconnect your lines.

Disclaimer
The information herein is based on sources we believe to be reliable but is not guaranteed by us and does not purport to be a complete or error-free statement or summary of the available data. As such, we do not warrant, endorse or guarantee the completeness, accuracy, integrity, or timeliness of the information. You must evaluate, and bear all risks associated with, the use of any information provided hereunder, including any reliance on the accuracy, completeness, safety or usefulness of such information. This information is not intended to be used as the primary basis of investment decisions. It should not be construed as advice designed to meet the particular investment needs of any investor. This report is published solely for information purposes, and is not to be construed as financial or other advice or as an offer to sell or the solicitation of an offer to buy any security in any state where such an offer or solicitation would be illegal. Any information expressed herein on this date is subject to change without notice. Any opinions or assertions contained in this information do not represent the opinions or beliefs of FactSet CallStreet, LLC. FactSet CallStreet, LLC, or one or more of its employees, including the writer of this report, may have a position in any of the securities discussed herein.

THE INFORMATION PROVIDED TO YOU HEREUNDER IS PROVIDED "AS IS," AND TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, FactSet CallStreet, LLC AND ITS LICENSORS, BUSINESS ASSOCIATES AND SUPPLIERS DISCLAIM ALL WARRANTIES WITH RESPECT TO THE SAME, EXPRESS, IMPLIED AND STATUTORY, INCLUDING WITHOUT LIMITATION ANY IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, ACCURACY, COMPLETENESS, AND NON-INFRINGEMENT. TO THE MAXIMUM EXTENT PERMITTED BY APPLICABLE LAW, NEITHER FACTSET CALLSTREET, LLC NOR ITS OFFICERS, MEMBERS, DIRECTORS, PARTNERS, AFFILIATES, BUSINESS ASSOCIATES, LICENSORS OR SUPPLIERS WILL BE LIABLE FOR ANY INDIRECT, INCIDENTAL, SPECIAL, CONSEQUENTIAL OR PUNITIVE DAMAGES, INCLUDING WITHOUT LIMITATION DAMAGES FOR LOST PROFITS OR REVENUES, GOODWILL, WORK STOPPAGE, SECURITY BREACHES, VIRUSES, COMPUTER FAILURE OR MALFUNCTION, USE, DATA OR OTHER INTANGIBLE LOSSES OR COMMERCIAL DAMAGES, EVEN IF ANY OF SUCH PARTIES IS ADVISED OF THE POSSIBILITY OF SUCH LOSSES, ARISING UNDER OR IN CONNECTION WITH THE INFORMATION PROVIDED HEREIN OR ANY OTHER SUBJECT MATTER HEREOF.

The contents and appearance of this report are Copyrighted FactSet CallStreet, LLC 2022 CallStreet and FactSet CallStreet, LLC are trademarks and service marks of FactSet CallStreet, LLC. All other trademarks mentioned are trademarks of their respective companies. All rights reserved.