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Compass Diversified Holdings, Inc. (CODI)

Q2 2019 Earnings Call

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Analyst, CJS Securities, Inc.

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning. And welcome to Compass Diversified Holdings Second Quarter 2019 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
Senior Account Executive, The IGB Group

Thank you. And welcome to Compass Diversified Holdings second quarter 2019 conference call. Representing the company today are Elias Sabo, CODI's CEO; Ryan Faulkingham, CODI's CFO; and Pat Maciariello, COO of Compass Group Management.

Before we begin, I would like to point out that the Q2 press release including the financial tables and non-GAAP financial measure reconciliations are available at the Investor Relations section on the company's website at www.compassdiversifiedholdings.com. The company also filed its Form 10-Q with the SEC last night, which includes reconciliations of non-GAAP financial measures discussed on this call.

Please note that references to EBITDA in the following discussions refer to adjusted EBITDA as reconciled to net income in the company's financial filings. The company does not provide a reconciliation of the ratio of its estimated cash flow available for distribution and reinvestment to its distribution. This is because certain significant information is not available without unreasonable efforts including, but not limited to, the company's future earnings, current taxes, capital expenditures and the distribution to be paid as approved quarterly by the company's Board of Directors. Throughout this call, we will refer to Compass Diversified Holdings as CODI or the company.

Now allow me to read the following Safe Harbor statement. During this conference call, we may make certain forward-looking statements, including statements with regard to the future performance of CODI and its subsidiaries. Words such as believes, expects, projects, and future or similar expressions are intended to identify forward-looking statements. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions.

Certain factors could cause actual results to differ on a material basis from those projected in these forward-looking statements and some of these factors are enumerated in the Risk Factor discussion in the Form 10-Q as filed with the Securities and Exchange Commission for the quarter ended June 30, 2019, as well as in other SEC filings.

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

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 morning. Thank you all for your time, and welcome to our second quarter earnings conference call. I will start by highlighting our significant accomplishments in the first half of 2019, which have exceeded our expectations in terms of value creation. Specifically, we executed two highly successful divestitures generating gains in excess of $300 million and increasing our total gains realized since our IPO to over $1 billion. We continue to see improvement in 5.11's financial results, which exceeded our expectations. Our remaining subsidiaries are performing largely in line with expectations.

However, our Velocity Outdoor subsidiary continues to be impacted by current challenges in the outdoor industry and has performed slightly below expectations thus far in 2019. Pat will speak more to our subsidiary company highlights in his section. We are also pleased that our CAD exceeded our distribution in the first half of the year, seasonally our slowest period. Based on the considerable success we have had year-to-date, we entered the second half of the year with the strongest balance sheet in CODI's history. Subsequent to quarter's end, we repaid $193 million of our term loan B leaving us with approximately $280 million in cash and more than $850 million in liquidity. Ryan will provide further details toward the end of our last call. Lastly, Compass Group Management, our Manager, volunteered to wave management fees due on cash.

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

During the second quarter of 2019, consolidated subsidiary revenue and EBITDA decreased by 4.2% and 6.7%, respectively, on a pro forma basis for the second quarter of 2018. As previously mentioned, impacting our consolidated results during the quarter were two items at Velocity Outdoor. First, in the second quarter of 2018, Velocity Outdoor fulfilled a large JROTC contract which does not repeat on an annual basis. Second, we acquired Ravin Crossbows into Velocity Outdoor in September 2018 and have communicated consistently that Ravin was filling stocking orders throughout 2018. And as a result, 2019 comparisons would be difficult.

This was anticipated in the acquisition of Ravin and the acquisition price we paid reflected normalized earnings, excluding the fulfillment of destocking orders. Excluding Velocity Outdoor given the distortion from these two events in 2018, consolidated pro forma subsidiary revenue and adjusted EBITDA for the second quarter of 2019 increased by 0.7% and 2.8%, respectively, as compared to last year. For the first half of 2019, consolidated pro forma subsidiary revenue and adjusted EBITDA, excluding Velocity Outdoor increased 1.4% and 4.5%, respectively.

Growth in the second quarter of 2019 decelerated slightly from growth in the first quarter due principally to slower macroeconomic conditions. For the three months ended June 30, 2019, CODI generated cash flow available for distribution and reinvestment, which we refer to as CAD of $26.2 million. For the six months ended June 30, 2019, CODI generated CAD of $43.8 million, essentially flat with the six-month period ending June 30, 2018, despite having higher financing costs in 2019 due to the Series B Preferred Stock issuance in March of 2018 and the debt refinancing in April of 2018. We are pleased with our CAD during the first half of 2019, which has exceeded our expectations. This is due to slightly better than expected subsidiary EBITDA, reduced management fees, as a result of waiving fees on cash and lower maintenance capital expenditures and cash taxes.

As a reminder, our capital expenditure and cash taxes can vary greatly from quarter to quarter and we anticipate the lower capital expenditures and cash taxes from the first half of 2019 to be made up for over the balance of the year. Our year-to-date financial performance has met our expectations and we continue to expect our consolidated subsidiary adjusted EBITDA to grow for the full year 2019 over pro forma adjusted 2018, notwithstanding the decline year-to-date. Based on our $1.44 per share annual distribution, we expect an annual CAD payout ratio of 85% to 95%, up slightly from 75% to 95% expectation last quarter, as a result of the two divestitures thus far in 2019. Ryan will provide further details in his comments.

For the second quarter of 2019, we paid a cash distribution of $0.36 per common share, representing a current yield of 7.5%. This brings cumulative distributions paid since CODI's 2006 IPO to $18.24 per share or 122% of the IPO price. We also paid cash distributions on July 30, 2019 of approximately $0.45 per share on our 7.25% Series A Preferred Shares, and approximately $0.49 per share on our 7.875% Series B Preferred Shares. Both distributions cover the period from and including April 30, 2019, up to, but excluding July 30, 2019.

Before turning the call over to Pat, I'd like to welcome Larry Enterline to our Board of Directors. Larry was a valued partner as CEO of Fox during CODI's ownership and his expertise in the branded consumer space and experience growing a global public company will make him a strong addition. We look forward to his contributions and guidance as a board member.

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

Patrick A. Maciariello

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

Thanks, Elias. On a pro forma adjusted basis, first half 2019 revenue and adjusted EBITDA for our niche industrial businesses was essentially flat compared to 2018. These results were in line with our expectations. Advanced Circuits financial performance met our expectations. However, performance declined from the first to second quarter of 2019, as a result of a slower macroeconomic environment. Foam Fabricators performed slightly better than expectations as the company continues to aggressively manage its raw material input cost.

So as Arnold Magnetics and Sterno performed in line with expectations despite being down slightly from year-ago period, we continue to expect both from growth-to-growth from both Arnold and Sterno on a full year basis. However, the timing of certain orders has shifted from a year ago. Arnold continues to execute against this strategic goal of increasing a proportion of Aerospace & Defense business, would now represent approximately 34% of its overall business. Arnold also had a book-to-bill ratio of 1.09 for the year-to-date period.

Now turning to our branded consumer businesses. On a pro forma adjusted basis, first half 2019 revenue and adjusted EBITDA for our branded consumer businesses was down 3% and 6%, respectively. Excluding Velocity Outdoor, revenue and adjusted EBITDA grew by 4% and 16% exceeding our expectations. Ergobaby's results were roughly flat compared to 2018 meeting our expectations. Liberty Safe's revenues were also roughly flat compared to last year. However, earnings were down due to capitalized inventory variances from 2018 releasing into 2019 earnings. Liberty's results were in line with our expectations. However, we see Liberty returning to strong growth in the back half of 2019 as the company rolls out product with a new large farm and fleet customer.

As Elias mentioned, Velocity's results were significantly below a year ago. Most of this decline, however, was anticipated as the company fulfilled a large junior ROTC contract in 2018 and Ravin fulfilled significant stocking orders identified in our underwriting of the business. The negative comparisons for junior ROTC can't afford the junior ROTC contracts are now behind us, and Ravin stocking order comparisons are expected to last only through the third quarter of 2019.

Despite the tough comparison in the last year, Velocity has made some important operational progress. Notably, the integration of Ravin is tracking ahead of plan and its consolidated all three business achieved recent recognition from Outdoor Life as is Ravin R26 was editor's choice and at CenterPoint Amped 415 Crossbow was named the best buy for 2019.

In addition, Velocity appointed Tom McGann as Executive Chairman. Tom is an exceptionally skilled leader and most recently was CEO of K&N Filters. We welcome Tom to the management team of Velocity.

Finally, our 5.11 subsidiary continues to exceed our expectations on multiple fronts. Our operational efficiency continues to improve. We are making progress against our strategic roadmap and our financial performance is exceeding expectations. In the second quarter of 2019, 5.11 grew sales by approximately 10% and adjusted EBITDA by 43%, a slight acceleration from the first quarter's revenue growth in revenue and adjusted EBITDA of approximately 5% and 41%, respectively. The new management team under the direction of Francisco Morales, CEO; Matt Hyde, Executive Chairman; and Jim McGinty, CFO, is doing an exceptional job and exceeding expectations.

The company continues to execute against the strategic growth plan in the consumer lifestyle segment, while maintaining its aspirational appeal in the professional segment. Consistent with our strategic goals, the company derived 50% of its domestic revenue from its consumer lifestyle segment in the second quarter of 2019 and 49% on a year-to-date basis, with our direct-to-consumer business growing fastest within the portfolio. It should also be noted that the first half of 2019 contained very little Direct-to-Agency business, further demonstrating the strength of the business and the company's accelerating earnings power. We are pleased with the performance of 5.11 and believe this business will be our fastest growing subsidiary on a long-term basis with transformational potential to the entire CODI business.

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

Ryan J. Faulkingham

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

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

As Elias previously mentioned, we executed two highly successful divestitures during the first half of 2019 generating gains in excess of $300 million bringing our total gains realized since our IPO to over $1 billion. During the first and second quarter of 2019, we repaid the remaining balance on a revolving credit facility and had availability of $600 million on the revolver at June 30, 2019.

In addition, we retained cash on our balance sheet at June 30, 2019, of approximately $480 million. Our consolidated leverage ratio was below 1.9 times at June 30, 2019. Subsequent to quarter end, we used cash to repay a portion of our term loan. We prepaid $193.8 million leaving us with more than $850 million of liquidity. The partial repayment of the term loan will save us approximately $5 million and net interest cost on an annualized basis. Our remaining sizable cash balance is currently earning just under 2%.

Finally, as Elias highlighted earlier in his remarks, the remaining eight businesses are producing cash flow that we believe will allow us to exceed our distribution for the remainder of 2019 and on an annualized basis. As a result of the loss of cash flow from the sales of Manitoba Harvest and Clean Earth slightly offset by the resulting lower interest cost and management fees, we believe our payout ratio will be between 85% and 95% for the full year 2019.

Moving to our consolidated financial results for the quarter ended June 30, 2019. I will limit my comments largely to the overall results for our company since the individual subsidiary results are detailed in our Form 10-Q that was filed with the SEC yesterday.

On a consolidated basis, revenue for the quarter ended June 30, 2019, was $336.1 million, down 1.1% compared to $340 million for the prior-year period. This year-over-year decrease reflects notable revenue growth at our 5.11 subsidiary offset by declines in our Velocity Outdoor subsidiary and our niche industrial businesses as a result of declining macroeconomic conditions. Consolidated net income for the quarter ended June 30, 2019, was $218.2 million as compared to $0.5 million in the prior-year quarter.

During the second quarter of 2019, CODI recorded a gain on the sale of Clean Earth of $206.3 million. CAD for the quarter ended June 30, 2019 was $26.2 million compared to $30.3 million in the prior-year period. The decline in CAD during the quarter was a result of our Series B Preferred Stock issuance in early 2018 as well as the higher revolver interest cost associated with our Ravin acquisition in September 2018, offset by reduced maintenance CapEx and lower management fees.

As Elias mentioned earlier, our maintenance capital expenditures and cash taxes can vary greatly from quarter-to-quarter and we anticipate the lower CapEx and cash taxes from the first half of 2019 to be made up for over the balance of the year.

Turning now to capital expenditures. During the second quarter of 2019, we incurred $4.4 million of maintenance CapEx compared to $6.1 million in the prior-year period. The decrease in maintenance CapEx was primarily related to lower spend at Velocity Outdoor. During the second quarter of 2019, we continued to invest growth capital spending $3.9 million, primarily at our 5.11 business.

For the full year of 2019, we expect to incur maintenance CapEx of between $25 million and $30 million and anticipate growth CapEx spend of between $10 million and $15 million, as we continue to invest in the long-term growth of our subsidiaries. The largest share of our growth CapEx spend will be to support 5.11's long-term growth objectives.

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

Elias J. Sabo

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

Thank you, Ryan. We are pleased with our performance in the first half of 2019, unlocking significant value for our shareholders with the attractive sales of Manitoba Harvest and Clean Earth, generating over $300 million of gains on a consolidated basis. We continue to see improving performance from our 5.11 subsidiary, which we believe has transformational potential to the entirety of CODI. Our balance sheet remains the strongest in our history and despite our record amounts of available capital, our earnings remains solid and we expect to continue to exceed our $1.44 per share annual distribution. Lastly, our Manager has volunteered to wave management fees on cash in a move that demonstrates our alignment of interest with our stakeholders.

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

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

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] First question comes from Dave King from ROTH Capital. Your line is now open.

Dave King
Analyst, ROTH Capital Partners LLC Q

Thanks. Good morning, guys.

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

Good morning, Dave.

Dave King
Analyst, ROTH Capital Partners LLC Q

I guess, first off on some of the subsidiaries, just trying to get a sense on Ergo, [ph] TRU (00:21:08) bankruptcy is now behind you, just trying to get a sense – what's sort of the outlook for that business as we move forward? Are there still some headwinds, or are there some things that now look like there could be some green shoots on the horizon? Just kind of put some color there. Thanks.

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

Hey, Dave. This is Pat. I think solid low single-digit growth is kind of what we see for the back half of the year. I think we have some exciting new products coming to market that will hit towards the end of Q3, beginning of Q4. So steady as she goes is kind of how I describe her though.

Dave King
Analyst, ROTH Capital Partners LLC Q

Okay. And then on Velocity and Liberty, seems like Liberty – maybe sometimes it's starting to go right there, that's still a challenging backdrop just – Velocity is still having its challenges though. Just trying to get a sense of where we in the kind of gun, shooting sports, cycle and – are you seeing any signs of optimism out there as we get closer to the 2020 election. Is it still always off and what you said?

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

Dave, I'm going to let Dave Swanson speak to the market conditions. What I would say is overall on Liberty, our team has done truly an exceptional job there as you've identified this is a really tough backdrop. And for us to continue to generate the kind of revenue and margins, I think it's really nothing short of exceptional what they've been able to do there. We've indicated on this call that they are expanding with a new very large farm and fleet customer. And so we look at the back half there and into 2020 as having real momentum outside of any industry changes that could happen. If there is industry changes to happen with the 2020 presidential election, that can only be gravy on top. But with respect to Liberty, I would say, they're really doing an extraordinary job. But I'll let Dave comment on the backdrop of the industry and sort of what we're experiencing right now.

David P. Swanson
Partner & East Coast Managing Partner, Compass Diversified Holdings, Inc.

A

Yeah. I would say from an industry perspective, we're still seeing some headwinds. A lot of it, I think, just has to do with some disruption in the outdoor retailers and some of the changes in the distribution channels. To your question on the election, I think that remains a wild card at this point. We probably haven't seen any impact. But historically, it's had some, but I think it's maybe too early to predict how that will play out. So in the meantime, as Elias mentioned, we're focused on the things that we can control and have initiatives at both Liberty and Velocity to fight some of the industry headwinds.

Dave King
Analyst, ROTH Capital Partners LLC

Q

Okay. That's good color. Thank you. And then, maybe taking a step back high level with now Clean Earth and Manitoba behind you, what's the plan or outlook for further divestitures? And what – it seems like sort of a frothy environment. How comfortable are you in bringing down the portfolio further? Would you consider – what would it take to maybe consider even doing an IPO something like 5.11, what are your some of the thoughts there? Thanks.

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

A

Yeah. Dave, so it's a very good question and we're always looking at kind of the portfolio, the earnings power that we have. Our view has and will continue to be that – all of our assets are available for sale. It's all a matter of price. And so, we love the portfolio that we have right now. We have a really great mix, I think as we identified at our Investor Day, we have a great mix of high free cash flow companies that are very defensible within their industries and then sprinkled with one really fast grower in 5.11. And I think that's a kind of nice composition of our portfolio, because it creates the free cash flow that we seek as investors and then on top of that it gives us some growth with 5.11 that can leverage up the entire portfolio growth.

All that being said, we remain opportunistic in divesting businesses, if that's the appropriate strategy, and if what we can get on a company, the value of it exceeds what we believe the value is to our shareholders by continuing to hold.

So we remain open to it and to the extent that we get the proverbial offer, we can't refuse. Everything is on the table and specifically you mention would we consider an IPO of 5.11, I think if the valuation was right for that business and it was right in its history, that clearly is on the table as well.

Dave King
Analyst, ROTH Capital Partners LLC

Q

Okay. Great. Well, thanks for taking all my questions, guys.

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

A

Thank you.

Operator: Next question is from Larry Solow from CJS Securities. Your line is now open.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Great. Thanks. Good morning, guys. Just one global and then one specific [indiscernible] (00:26:40) question. Just on the global, any noted change through the quarter as the quarter or as the year has progressed? I know you were strongly towards the end of economic growth, and certainly slowing down there, are you guys seeing any of that in your businesses, particularly on the industrial side?

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

A

Yeah. So Larry, I would say our industrial companies typically are going to react to changes in the macroeconomic environment faster than our consumer, because our consumer are really such niche businesses and generally are more enthusiast businesses that they don't follow the traditional economic patterns. They have more unique patterns that they follow.

So the industrial business is as we saw throughout the quarter, frankly did see some weakening. And I would say the second quarter as we identified in our script, the second quarter was a little bit weaker than the first quarter and it did progress throughout the quarter, I would say, most notably was Advanced Circuits. And this has been such a great business that we've held over now 13 years as a public company, but what we all know with Advanced Circuits, it is our shortest cycle business, right. I mean, our order backlog is typically a day or two, right, especially for our core quick turn out of Aurora. And we saw that that business sort of weakened and we're now seeing some of the competitors in the industry that report publicly, also had dramatically lower results. In fact, Advanced performed significantly better than what we think the industry did, at least by virtue of what we've seen the public competitors out there.

So we remain pleased with that asset. However, it's sort of – kind of at least let the acceleration down or the deceleration in growth. So it gave us a little bit of concern and I would say it's probably made us a little bit more cautious going into the back half of the year. I think there's at least – via the markets there's a belief that some easing of financial conditions will kind of help stabilize or restore some economic growth. I think that – hopefully that is the case. There's no question that we did see, in the industrial portfolio, general weakening and I would say June ended up weaker than where March was. And now that's not to say that it does bring us into a slightly lower point starting in Q3. But again, a lot will depend on the macroeconomic conditions where inventory changes are which – the farther down the supply chain you are the more you get impacted by it.

So it's given us a slightly more cautious view, which we've incorporated into the guidance that we've provided today.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Okay, great. And then just switching gears just quickly on 5.11. As noted, a good solid quarter, I think, if I had calculated correctly, I think EBITDA margins were above 12% and probably the highest it had been in a couple of years. So looks like the warehouse consolidation that played you last several quarters is, hopefully I think in the past.

Going forward, I know you guys are focused on growing the business, but we need to invest more in SG&A, or is that a plan or which will make – impact margins a little bit going forward, or do you – or should we expect sort of an operating leverage and further improvement on the margin side?

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

A

So I'm going to say both, yes and yes. We think there's a lot of upside in this business, Larry. I mean, we highlighted, hopefully everybody who attended our Investor Day was able to see what this company's opportunity is and experience, the retail pop up store that we had there. And just how it is positioned differently and it's pretty much creating a new opportunity in the marketplace. So that's why we are so excited about this company and continue to throw around the word transformational with respect to its potential for all of CODI.

I would say, we believe that there is a lot of margin potential to be had in this business, clearly 12% for a company like this is nowhere near what the target margin should be. Now that being said, I think that the question – and we've started to switch gears here, as you mentioned, the investments we made in the warehouse in the ERP, they're behind us. We're starting to get the productivity benefits that come along with that. And we think those are going to be realized for years to come. Against that though and on the other side is really investing more in marketing and advertising to elevate the brand awareness, so that this company ultimately can be valued at a much greater rate, right. Accelerating our retail comps, accelerating our consumer lifestyle growth business, we think ultimately on an exit, it's going to get a much bigger valuation multiple. So, if we sacrifice a little bit kind of in margin and earnings potential, we think we get paid back multiple times on the other side.

So we're very analytical, everything comes down to what type of return we can generate on incremental [ph] ad spend (00:32:22) and incremental marketing dollars, I would say we believe from some of the things we're doing there right now that data is very supportive of adding incremental spend here and driving considerably faster growth. And so we continue to evaluate that. So I think that margins will continue to grow notwithstanding all of that. And we believe that just kind of opportunity for growth and the opportunity to bring out productivity gain even – with some margin growth, will free up a bunch of additional dollars to accelerate our marketing and advertising investments.

Larry S. Solow
Analyst, CJS Securities, Inc.

Q

Got it. Great. Thank you.

Operator: Next question is from Kyle Joseph from Jefferies. Your line is now open.

Kyle Joseph
Analyst, Jefferies LLC

Q

Hey, good morning, guys. Congratulations on a good quarter and thanks for taking my questions.

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

A

Good morning, Kyle.

Kyle Joseph
Analyst, Jefferies LLC

Q

I wanted to go back. It sounds like there's definitely some signs of macro slowing at least on the industrial companies. I just wanted to get a sense, are you seeing any sort of signs of multiple recoveries or reduced multiples in middle-market M&A at all as a result of that? I'm just trying to connect the dots there.

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

A

The short answer is no. There is a tremendous amount of capital continuing to chase deals and that's both – that's across all components of the capital structure, think as everybody is aware the bond market is kind of really strong right now that facilitates middle-market, higher middle-market transactions for sure. And the amount of private equity capital that's in the marketplace is very, very high. So we have not seen a relief of multiples yet. And we might need to see – probably would likely need to see further deceleration in economic growth before we see that. That would just be our guess, but as of right now we have not seen any relief.

Kyle Joseph
Analyst, Jefferies LLC

Q

Got it. And then one final one from me, you guys talked about – obviously your balance sheet is in tremendous shape. You talked about paying off the term – a portion of the term loan, but can you just walk us through your capital allocation priorities now given the market conditions given your balance sheet strength in terms of add-on acquisitions further debt pay downs or potential capital returns?

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

A

Yes. So Kyle is going to be fluid, to be honest with you, I would say, our goal is to retain availability and liquidity to be able to move quickly, because that's a real competitive advantage that we have in the marketplace, especially in times where there's some type of market dislocation. And so having a little bit of excess liquidity – we all understand there is a cost to doing that, right. But the benefit on the other side is the ability to move quickly without financing contingencies in a time of market dislocation can create incredible upside opportunity for our shareholders over the long-term. And so we believe maintaining a little bit of excess liquidity is going to be a prudent and responsible thing.

And today, when I say a little bit is the amount of cash that we have on hand, because largely we could take that cash and repay a portion or all of our term loan B and we could save kind of the incremental savings between the interest we earn on cash, and what we pay on the term loan B.

And so that is something that in the near-term we're suffering that cost. Obviously, that gets born in the guidance that we've provided here. But we think the opportunity to put that money to work is worth far more than making a short-term capital decision. Now if we continue to go for an elongated period of time without being able to find opportunities to put the market to work, which is not our base assumption, by the way. We still believe that we can execute against the eight remaining portfolio companies with add-on acquisitions, to the extent though that conditions are just so adverse to being a buyer in the marketplace that we can't get any money or work then we would re-evaluate and then that's where I would say it will be a little fluid.

But our current viewpoint is, maintaining this liquidity over the intermediate and long-term, we think is going to really generate significant value creation for our shareholders notwithstanding a kind of minor cost that we incur in the near-term.

Kyle Joseph
Analyst, Jefferies LLC

Q

That makes a lot of sense. Thanks very much for answering my questions.

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

A

Thank you.

Operator: [Operator Instructions] [Operator Instructions] Your next question is from Matt [indiscernible] (00:37:37) from Raymond James. Your line is open.

Q

Hi, everyone. Good morning. I'm on the line for Robert. One question to start off. We know on the previous conference call from Q1, you pointed to guidance over the near-term future over the next year to be more of net sellers than buyers. Do you think that's still applicable over the next year and have you seen anything quarter-over-quarter that would have changed that?

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

A

Yeah. I would say today we probably think we are net neutral, if we were net divestors a year ago, it was our view today we would view ourselves as being more like net neutral.

Q

Okay. Great. And then secondly, I know we've discussed Velocity a lot today. Can you provide any more color on kind of how far through the cycle they are, but more so as well, what's your confidence level for growth as it relates to 2020?

David P. Swanson
Partner & East Coast Managing Partner, Compass Diversified Holdings, Inc.

A

Yeah. So I think as mentioned, we're working through some tough comps certainly in the first half and continuing into the third quarter on the Ravin side in terms of comps. I'd say there is obviously a lot of work being done, we're dedicating a lot of resources at Compass. As mentioned in the remarks, we've added an Executive Chairman that we think will be very, very helpful in doing a lot on the product development side. The product development side takes a little more time to come to fruition. So I'd say uncertain in the short-term, we feel like we'll be able to return to a growth trajectory more medium-term in some of these efforts that were undertaking [ph] bear fruit. (00:39:27)

Kyle Joseph
Analyst, Jefferies LLC

Q

Great. Thank you.

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

A

Thank you.

Operator: I am showing no further questions at this time. I would now like to turn the conference back to Elias Sabo.

Elias J. Sabo

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

I would like to thank everyone, again, for joining us on today's call and for your continued interest in CODI. We look forward to sharing our progress with you in the future. Thank you.

Unverified Participant

Thank you.

Operator: Ladies and gentlemen, this concludes today's Compass Diversified Holdings Q2 2019 earnings conference call. Thank you for your participation. You may now disconnect.