

Smith & Wesson Holding Cop

NASDAQ:SWHC

Analyst: Guillaume Valentin

Sector: Industrial goods

BUY

Price Target: \$24.74

Key Statistics as of 03/09/2015

Market Price:	\$13.00
Industry:	Aerospace/defense products
Market Cap:	\$689.9
52-Week Range:	\$9.03-\$17.28
Beta:	1.08

Thesis Points

- Opportunities for market growth
- Strong emphasis on advertising and R&D
- Vertical integration
- U.S. Army opportunity
- Financial highlight

Company Description

Smith & Wesson, founded in 1852 and based in Springfield, Massachusetts, manufactures and sells firearms products in the United States and internationally. The company offers the following products: handguns (revolvers and pistols), long guns, hunting rifles, black powder firearms, handcuffs and firearms-related products and accessories. The company target both law enforcement and security agencies and individuals. The company also operates an online retail store to sell firearms accessories. The company sells its products under the Smith & Wesson, M&P, Thompson/Center Arms, and Performance Center brand names



Thesis

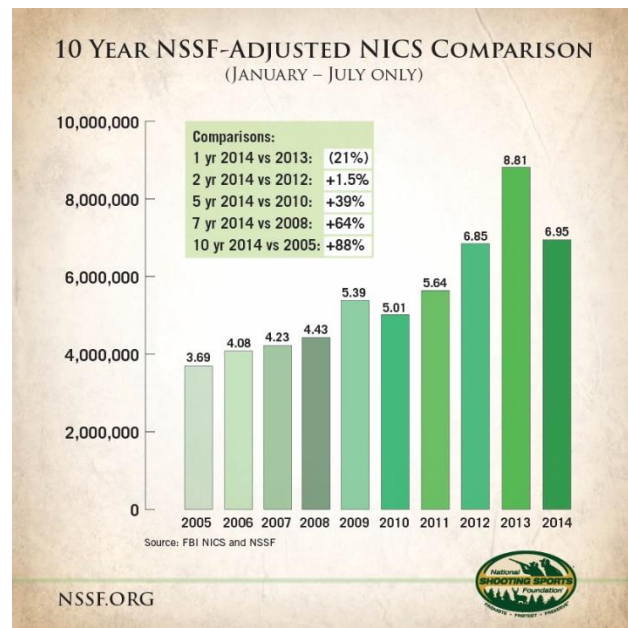
Smith & Wesson manufactures and sells firearms products top individual customers and professionals in the United States and internationally. The company is part of an industry than have been significantly growing over the past decade. In order to target new customers, the company had put an emphasis on research and development and marketing, by targeting women and first-time shooters. The company has recently pursued a vertical integration in order to be more competitive and more aggressively target its customers. Finally, the probability of a huge contract with the U.S. Army would eventually boost sales. With a very low P/E ratio, the company is currently undervalued.

Business overview



Smith & Wesson sells its products to both consumer and professional markets. For Q3FY2015 the company sold 89% of its products to the consumer market. In this market, firearms are used for sport and competition, personal defense, hunting and concealed carry. Consequently, the company sold 11% of its products to the professional customers. Professional customers use firearms for law enforcement, military, government. International sales are included in the professional segment. Finally, the company has two divisions in its business: firearms and accessories. The company sells its products under three brands: “Smith and Wesson” for sport, recreation, protection, and professional use. This brand has been on the firearms market for 162 years. Additionally, “M&P” brand is designed to be the most accurate, reliable, and ergonomically superior firearms brand. They are built to meet industry standards and their main qualities are to be durable and comfortable. Finally “Thompson Center” designs hunting and shooting guns since 1967. The company also offers limited edition and personalized “Smith and Wesson” and “M&P” firearms under its “Performance Center” division. The company is able to reach a broad range of customers thanks to the diversity of its products that can be used for many purposes.

Industry



¹ <http://www.calgunlaws.com/us-gun-industry-sales-reflect-a-new-normal/>

The chart above shows the total firearm sales in the United States from 2005 to 2014. We can see that sales rose at a compound annual growth rate of 6.54% from 2005 to 2014. Last year was an extraordinary one for firearm sales, a year unlike any other in the industry's history. In overall we can see a trend of almost uninterrupted rise over the past 10 years. Those who are hostile to firearms argue that people are no longer interested in guns because of the decline in sales in 2014. However, this was more attributable to a normalization of sales after an unusual volume of sales in 2013 said Steve Sanetti., NSSF President and CEO. According to a "Gallup Poll Social Series survey", the breakdown of top reasons for gun ownership is described as followed: Personal Safety/Protection - 60%, hunting - 36%, Recreation/Sport - 13%, Target Shooting - 8%. The company has also the opportunity to increase pistol sales to further align with the market. In 2010, the pistols to revolvers ratio was 1.4:1. This ratio is expected to increase to 4.1:1 in FY2014. It means that consumers are more and more interested in pistols. Smith and Wesson should take advantage of this market opportunity. The company should finally focus on two segments: new shooters and repeat customers. Concerning new shooters, in 2012, about 11% of sport shooters just began shooting in 2012. 18-34 year old age group makes up about 2/3rd of new shooters. It means that these people might be interested in buying a gun for their own purpose. Additionally, 90% of people owning a handgun own multiple firearms. More importantly, those people own an average of 8.1 guns, which means that there is a huge market for gun renewal in the future. Smith & Wesson has the advantage to be one of the most famous brands in the firearm industry. It leads all firearm manufacturers in brand awareness. Even if the company is not the leader in sales in the industry, 1 out of 2 revolvers owned in the United States is a Smith & Wesson. It leads the industry in critical attribute ratings such as reliability, durability and accuracy, which makes it one of the best players to take advantage of these market opportunities. So even if Smith & Wesson is not ranked first in the number of units sold, it enjoys very strong brand recognition.

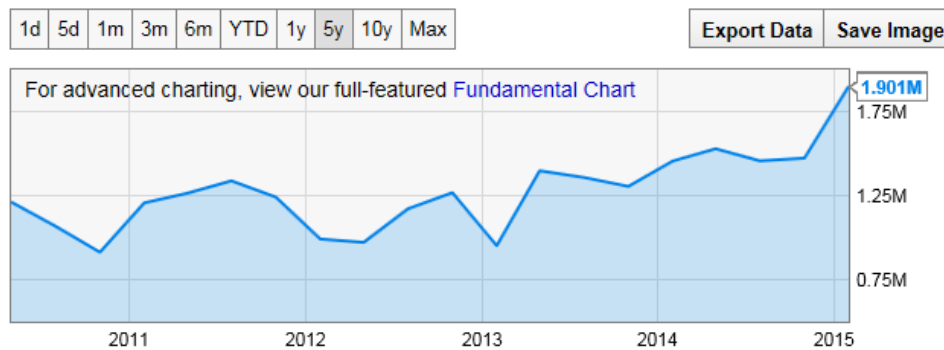
Strong emphasis on advertising and R&D

The company has a strong focus on research and development in order to develop new products and attract new customers in new markets. Smith & Wesson performs systematic review to track industry brands and consumer shifts, among its customers and new prospects. The company has a better understanding of its targeted customers thanks to proprietary information that portrays the average number and type of firearms owned by each individual. It results in a superior knowledge of the market and a better allocation of research and development capital spending. The company puts a lot of money in advertising in order to promote its brand.



Smith & Wesson is the sponsor of "Love at the First Shot", an NRA (National Rifle Association) series that focused on shooting sports for the first-timer. This series is presented by a Natalie Foster, which add brand recognition in both new shooters and women. The company also produces television and digital marketing campaigns geared toward women. The company is also the official provider of NRA-certified women instructors with eyes and ears protections. The NRA is nonprofit organization which aims to promote the constitutional right to keep and bear arms. It is the most powerful firearms organization in the United States and probably in the world. Therefore, Smith & Wesson is very well positioned in the market to promote its brand to prospects and existing customers. The company also designs guns that will be bought by women because of their specific look. Women currently represent 37% of new shooters versus 22% of established shooters. It means that in the long-run the proportion of women is established shooters is expected to increase. Smith & Wesson has understood this new market trend and is ready to take advantage of it. Additionally, as described below, the company has a strong emphasis on general research and development.

Smith & Wesson Holding Research and Development Expense (Quarterly) [View Full Chart](#) Chart



Smith & Wesson Holding Historical Research and Development Expense (Quarterly)

Above is the quarterly research and development spending of Smith and Wesson from 2011 to 2015. We can see that the company is spending more and more in R&D, with a record \$1.901 million for the quarter ending January 2015, even with a decline in sales during the last fiscal year. The company bases most of its new product development spending on market researches. The company performs surveys with firearm owners and purchase intenders. All of these results are benchmarked against a database of prior sales in order to forecast future demand. The company develops new products each year. For 2015, it has come with 5 new M&P firearms that have different available customizations. Additionally, 2 new Thompson hunting rifles will be launched during 2015. The company constantly produces new products in order to comply with any new expectations from customers.

Vertical integration

In May 2014, Smith & Wesson has announced the purchase of “Deep River Plastics”, a key polymer supplier. The deal was settled for \$24 M. Deep River Plastics delivers in-house custom plastic injection molding, rapid prototyping, and tooling that are extensively used in the manufacturing of firearms.² This purchase will incur several operational benefits for Smith and Wesson. It will increase flexibility in the production of firearms because the company will not rely anymore on a main supplier for the plastic used in its firearms. Additionally, it will lower production costs for the same reasons. By doing this vertical integration, the company reduces its risk within the supply chain. This acquisition is expected to have a positive impact in gross margin starting in Q3 2015. Smith & Wesson expects the payback period of this investment to be between 4 and 5 years, which is rather short. Additionally, Smith & Wesson successfully completed in December 2014 the acquisition Battenfeld Technologies for approximately \$130.5 million in cash. This company is the industry leader in providing hunting and shooting accessories. It will provide a broad and established platform for Smith & Wesson’s firearms accessories business. This acquisition is expected to increase gross margin and generate cash for the company starting in FY 2016. Additionally, the company paid for all of these acquisitions in cash, which means that its stock is currently undervalued.

U.S. Army Opportunity

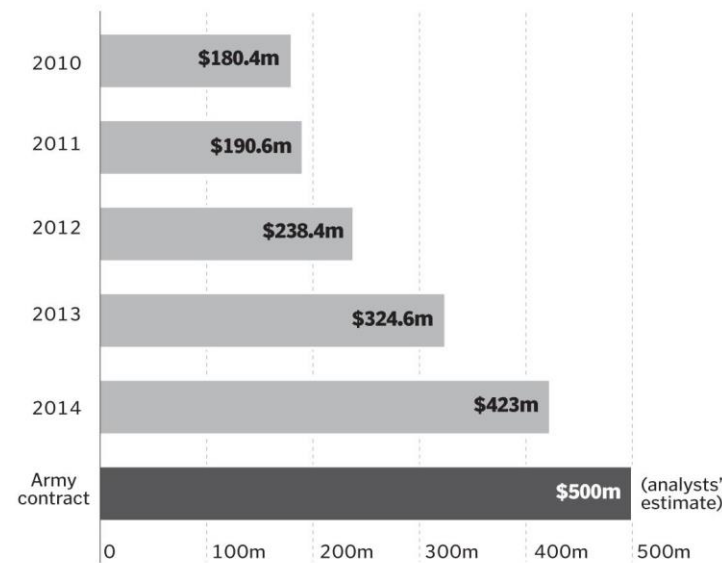
The Army announced that it will purchase new handguns anytime soon.³ The Army said it wants the new handgun to have “increased lethality, increased accuracy, improved ergonomics, and a higher degree of reliability/durability and shot larger bullets”. This can possibly be the best professional contract Smith & Wesson could ever have. In the past, Smith & Wesson has supplied firearms to the FBI and US Marshals, so it has experience with government contracts. Its last federal contract came in 1996. The Army is expected to buy about 500,000 weapons as well as ammunition and accessories. It would include a rollover contract for years to come. The whole contract would amount to about \$500 million, which would be more than the total sales of Smith & Wesson for 2014, as presented in the chart below.

² <http://ir.smith-wesson.com/mobile.view?c=90977&v=203&d=1&id=1911985>

³ <http://www.bostonglobe.com/business/2015/03/19/smith-wesson-takes-aim-army-pistol-contract/zfFukxIDJSkk4xg19zLuVK/story.html>

Aiming for a big contract

A single contract to supply pistols to the US military could surpass an entire year's worth of handgun sales by Smith & Wesson.



SOURCE: Smith & Wesson

KATHERINE LEE/GLOBE STAFF

Smith & Wesson is now waiting for the request of proposal. A request for proposal (RFP) is “a solicitation, often made through a bidding process, by an agency or company interested in procurement of a commodity, service or valuable asset, to potential suppliers to submit business proposals.” Originally scheduled for January 2015, the RFP could come anytime soon. When the U.S. Army released a draft RFP during the fall 2014, Smith & Wesson expressed its interest by announcing a partnership with General Dynamics Corp, a defense company, to pursue this handgun deal. All of Smith & Wesson’s competitors have remained silent about this opportunity. M&P pistols are strongly positioned to compete because they match all the U.S. Army requirements. If Smith & Wesson complete the deal its stock price will jump. Smith & Wesson has also the advantage of being an American company and a very famous brand in the gun industry.

Financials highlight

Smith & Wesson has a current P/E ratio of 13.68, which is significantly lower than the average 19.47 P/E of the market⁴ and the average of the industry, which means that the company is undervalued. Investors are not paying a lot considering the company’s earnings. The company targets long-term gross margins in the range of 37% to 41% and long-term EBITDA above 20%. Since the company did not reach yet these targets it will lead to further profitability improvements in the near future and will drive the value of Smith & Wesson up.



The company has a 41.58% debt to equity ratio. This value has been rather steady over the past 2 years. Additionally, the company has 8.40% of WACC, which is rather low. It means that Smith & Wesson operates at its optimal capital structure, and tries to maximize the value of the company. Finally, the company had steady revenues growth over the past three years. Its gross profit margin has increased. With the forecasted market opportunities in the near future, this is expected to increase further.

⁴ <http://www.multpl.com/>

CENTER FOR GLOBAL FINANCIAL STUDIES

Smith & Wesson Holding Corporation		SWHC	Analyst GUILLAUME VALENTIN	Current Price \$13.01	Intrinsic Value \$22.18	Target Value \$24.74	Divident Yield 0%	Target Return 90.17%	BULLISH
General Info		Peers	Market Cap.	Management					
Sector	Consumer Discretionary	Sturm, Ruger & Co. Inc.	\$941.91	Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2014	
Industry	Leisure Products	Callaway Golf Co.	\$745.68	Debnay, P.	Chief Executive Officer, Presiden	\$ 2,065,728.00	\$ 5,420,880.00	\$ 4,873,237.00	
Last Guidance	Mar-03-2015	Arctic Cat Inc.	\$492.76	Budhanan, Jeffrey	Chief Financial Officer, Principal	\$ 1,182,070.00	\$ 1,415,061.00	\$ 2,336,508.00	
Next earnings date	6/23/2015	Brunswick Corporation	\$4,828.65	Cicero, Robert	Chief Compliance Officer, Vice P	\$ 390,584.00	\$ 796,639.00	\$ 1,433,002.00	
Market Data		Remington Arms Company, LLC		Smith, Mark	Vice President of Manufacturing	\$ 780,614.00	\$ 892,634.00	\$ 1,396,246.00	
Enterprise value	\$930.51	Miroku Corporation	\$4,710.11	Sharp, Elizabeth	Vice President of Investor Relatic	\$ -	\$ -	\$ -	
Market Capitalization	\$933.35	Polaris Industries Inc.	\$9,365.07	McPherson, Deana	Vice President and Corporate Co	\$ -	\$ -	\$ -	
Daily volume	0.86	Colt Defense LLC		Historical Performance					
Shares outstanding	53.76	Vista Outdoor Inc.	\$2,710.49	SWHC		Peers	Industry	All U.S. firms	
Diluted shares outstanding	55.01	Harley-Davidson, Inc.	\$12,853.94	Growth	45.6%	2.4%	5.2%	6.0%	
% shares held by institutions	77.02%	Current Capital Structure			Retention Ratio	10.3%	12.3%	35.6%	61.6%
% shares held by insiders	1.80%	Total debt/market cap	29.55%	ROIC			31.1%	19.8%	11.8%
Short interest	17.87%	Cost of Borrowing	5.22%	EBITA Margin	10.1%	13.2%	10.1%	13.7%	
Days to cover short interest	7.56	Interest Coverage	1027.86%	Revenues/Invested capital	261.2%	214.3%	220.5%	202.3%	
52 week high	\$17.28	Altman Z	3.40	Excess Cash/Revenue	11.0%	9.8%	12.4%	18.5%	
52-week low	\$9.03	Debt Rating	BAA	Unlevered Beta	1.05	1.15	1.09	0.95	
5y Beta	1.08	Levered Beta	1.38	TEV/REV	1.3x	1.6x	1.1x	2.4x	
6-month volatility	41.34%	WACC (based on market value weights)	8.49%	TEV/EBITDA	9.2x	11.2x	10.8x	11.3x	
Past Earning Surprises				TEV/EBITA	13.1x	13.3x	12.1x	15.4x	
	Revenue	EBITDA	Norm. EPS	TEV/UFCF	8.0x	18.7x	28.6x	26.8x	
Last Quarter	4.6%	38.5%	66.7%	Non GAAP Adjustments					
Last Quarter-1	1.9%	22.3%	28.6%	Operating Leases Capitalization	100%	Straightline		10 years	
Last Quarter-2	-1.9%	10.6%	4.0%	R&D Exp. Capitalization	100%	Straightline		10 years	
Last Quarter-3	4.2%	16.6%	10.0%	Expl./Drilling Exp. Capitalization	0%	N/A		N/A	
Last Quarter-4	2.5%	10.0%	20.7%	SG&A Capitalization	0%	N/A		N/A	
Proforma Assumptions				Forecasted Profitability					
		Period	Rev. Growth	Adj. Op. Cost/Rev	Revenue	NOPLAT	Invested capital	UFCF	
Operating. Cash/Cash	0.0%	LTM	-8%	75%	\$541.29	\$65.99	\$425.04	-\$119.19	
Unlevered Beta	1.10	LTM+1Y	4%	73%	\$563.74	\$78.29	\$415.13	\$30.21	
Rev/Invested Capital	100.0%	LTM+2Y	4%	71%	\$586.12	\$88.03	\$422.82	\$80.34	
Continuing Period Revenue Growth	3.0%	LTM+3Y	3%	71%	\$606.16	\$94.81	\$429.61	\$88.03	
Long Term ROIC	14.0%	LTM+4Y	3%	70%	\$625.51	\$100.50	\$435.97	\$94.14	
Invested Capital Growth	Equals to Maintenance	LTM+5Y	3%	69%	\$644.98	\$105.72	\$445.00	\$96.68	
Justified TEV/REV	1.5x	LTM+6Y	3%	69%	\$664.77	\$110.79	\$452.36	\$103.43	
Justified TEV/EBITDA	8.0x	LTM+7Y	3%	69%	\$684.98	\$115.93	\$458.72	\$109.57	
Justified TEV/EBITA	12.0x	LTM+8Y	3%	68%	\$705.70	\$121.22	\$464.92	\$115.02	
Justified TEV/UFCF	12.0x	LTM+9Y	3%	68%	\$726.96	\$126.64	\$472.78	\$118.78	
Valuation									
	ROIC	WACC	EVA	Enterprise Value	Total Debt	Other claims	Equity	Adjusted Price	
LTM	27.5%	8.5%	\$42.37	\$1,472.76	\$275.00	-\$28.41	\$1,226.17	\$23.14	
LTM+1Y	19.0%	8.6%	\$42.76	\$1,504.04	\$275.00	-\$118.79	\$1,347.83	\$25.49	
LTM+2Y	21.2%	8.7%	\$52.40	\$1,563.20	\$275.00	-\$187.80	\$1,476.00	\$27.79	
LTM+3Y	22.4%	8.8%	\$58.01	\$1,610.94	\$275.00	-\$264.79	\$1,600.73	\$30.12	
LTM+4Y	23.4%	8.9%	\$62.65	\$1,655.74	\$275.00	-\$348.29	\$1,729.04	\$32.51	
LTM+5Y	24.2%	9.0%	\$67.41	\$1,698.92	\$275.00	-\$434.97	\$1,858.89	\$35.05	
LTM+6Y	24.9%	9.1%	\$71.02	\$1,744.45	\$275.00	-\$529.29	\$1,998.74	\$37.56	
LTM+7Y	25.6%	9.2%	\$74.89	\$1,788.10	\$275.00	-\$630.78	\$2,143.88	\$40.27	
LTM+8Y	26.4%	9.3%	\$79.14	\$1,830.47	\$275.00	-\$738.87	\$2,294.34	\$43.08	
LTM+9Y	27.2%	9.4%	\$83.85	\$1,871.38	\$275.00	-\$852.08	\$2,448.46	\$45.54	
Monte Carlo Simulation Assumptions				Monte Carlo Simulation Results					
	Base	Stdev	Min	Max	Distribution				
Revenue Variation	0	10%	N/A	N/A	Normal	Mean est.	\$23.14	\$25.49	
Op. Costs Variation	0	10%	N/A	N/A	Normal	σ(e)	\$0.32	\$0.25	
Market Risk Premium	6%	N/A	5%	7%	Triangular	3 σ(e) adjusted price	\$22.18	\$24.74	
Long term Growth	3%	N/A	2%	46%	Triangular	Current Price	\$13.01		
Terminal Value	0	0.1	N/A	N/A	Normal	Analysts' median est.		\$15.86	