



Weekly Credit Brief

transforming big data into smart data

Jul 19 - Jul 25

Mass shootings are boosting firearm stocks

by [Dexter Tan](#)

Gun sales are rising and so are the market values of firearm companies. The market capitalization of Smith & Wesson Holding Corporation, one of America's largest gun manufacturers, soared to an all-time high of USD 1.64bn on July 11, from USD 723mn in March last year. The company [reported](#) strong earnings in the recent two quarters as revenues increased by 61.5% YoY and 22.2% YoY in January and April, respectively. The company's robust top line growth tracked a [40%](#) nationwide increase in gun sales, which could set another record high by the end of 2016.

The 121% surge in Smith & Wesson's share value coincided with a considerable improvement in the company's creditworthiness in the last 16 months. The RMI-CRI 1-year Probability of Default (PD) for Smith & Wesson declined from 11bps to less than 1bps, a level on par with other investment grade US listed firms.

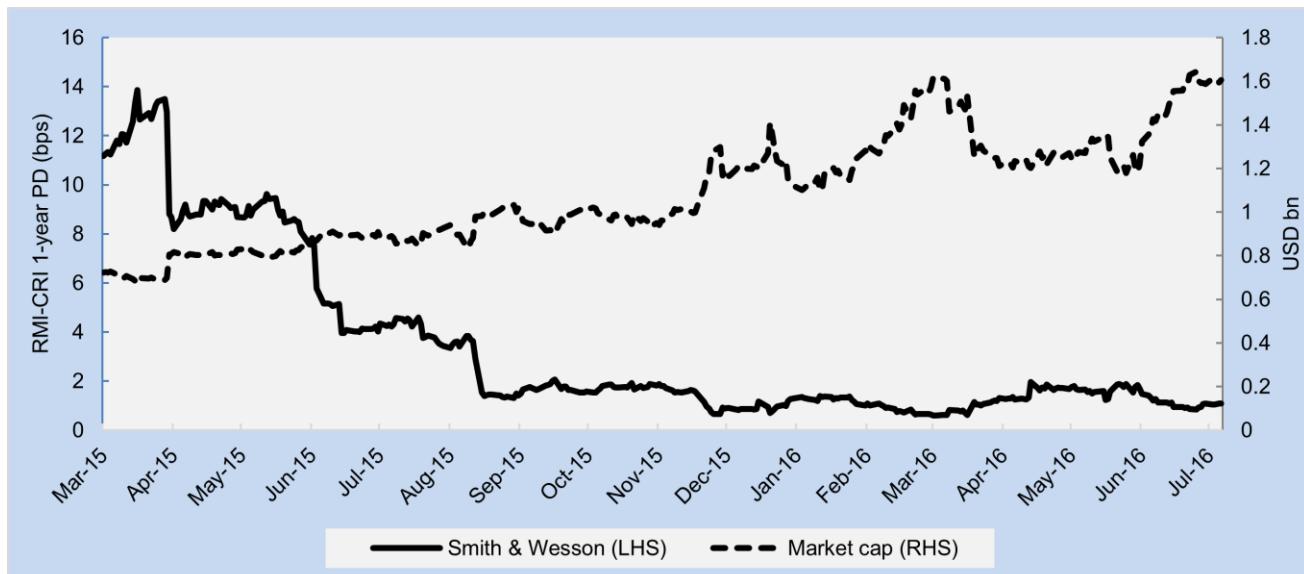


Figure 1: Market cap and 1-year PD for Smith & Wesson. Source: Bloomberg, RMI-CRI

Smith & Wesson's credit profile progression is reflected in a number of financial ratios (see Table 1). Its ability to service interest payments, for instance, has improved significantly due to higher sales and lower financing costs. For the 12 months that ended April 30, Smith & Wesson generated USD 158mn of earnings before interest and taxes. The company's trailing 12 month interest expense declined to USD 13mn, down from USD 16.6mn at July 2015. As a result, the ratio of EBIT / interest increased from 5.6X to 11.6X. The reasons for higher EBIT were twofold. First, Smith & Wesson's introduction of a new Military & Police (M&P) product line and the advertisements of their small concealed carry polymer pistols, have helped to improved consumer demand. Second, the present political and social environment has fueled an interest for firearms.

The other factor influencing the EBIT/ interest ratio was lower quarterly interest rates. Last year, the company signed a credit agreement with TD Bank and a few other lenders for a USD 105mn term loan, which was used to redeem a 5.875% senior note due 2017. Interest payments for the term loan, based on a variable rate, have been hedged through an interest rate swap. As of April 30, the payable swap rate is 3.06% but this could head lower as it is dependent on the firm's consolidated leverage ratio.

	Three months ending			
	July 31, 2015	October 31, 2015	January 31, 2016	April 30, 2016
Total debt / EBITDA (X)	1.36	1.22	0.97	0.86
T12M EBIT / Interest (X)	5.63	6.52	9.29	11.57
T12M Retained cash flows / debt (%)	68.1	80.3	91.0	97.5

Table 1: Financial metrics for Smith & Wesson. Source: *Bloomberg, company reports.*

With a 54% increase in EBITDA (earnings before interest taxes, depreciation and amortization), Smith & Wesson managed to reduce its leverage as reflected in its Total debt / EBITDA ratio reducing from 1.36X in July 2015 to 0.86X in April 2016. Debt serviceability strengthened as a result of higher EBITDA and a reduction in overall debt levels by USD 5mn to USD 172mn. The company took on a USD 175mn revolving line of credit last year but there were no outstanding borrowings on the revolving line. The firm's only outstanding bond is a USD 75mn 5% senior note due 2018.

Retained cash flows (RCF) as a percentage of total debt, increased during the four quarters. With nearly no change in debt, the RCF ratio exceeded 97 percent by the end of April. Trailing 12 month retained cash flows increased 39% to USD 168mn on the back of increased net income, a favorable accounts payable from an effort to negotiate longer terms with suppliers and higher payroll accruals due to greater management incentives.

Smith & Wesson operates in a competitive, tightly regulated firearm industry. The top three players in the sector, according to one [estimate](#), are Remington Outdoor, Sturm Ruger & Co and Smith & Wesson. Remington Outdoor is privately owned and has the largest market share. Frequent financial disclosure is not a requirement but Bloomberg estimates Remington's EBIT/Interest ratio to be -0.15X in September 2015. Remington's debt over total asset ratio is more than 84 percent, which exceeds Smith & Wesson's debt to total asset percentage of around 33 percent. The company is on the verge of default as reported by [Moody's](#), as it is highly leveraged. Sturm, Ruger & Co, is Smith & Wesson's closest competitor in the public market. Sturm Ruger has no debt and its 1-year PD has remained consistently below 1bps. Both companies have benefitted from the recent surge in gun sales.

The recent spike in gun sales follows a recurring pattern – more Americans are flocking to buy guns as the number of mass shootings increase. These unfortunate events have proved to be lucrative catalysts for these companies. However, the credit quality of gun manufacturers are highly susceptible to changes in federal and state laws. Any new law advocating a tighter control of firearms could still have a material adverse effect on the firms. Companies may find it expensive to comply with the new gun restrictions in certain jurisdictions, or might possibly hinder new product development and stop the distribution of existing firearms.

Credit News

Verizon to end Yahoo survival fight with USD 4.8bn deal

Jul 25. Verizon Communications Inc. will buy Yahoo's core assets for more than USD 4.08bn. Verizon will be tapping on Yahoo's millions of daily users on sites like Yahoo Finance to compete with Google and Facebook in the digital advertisement field. An analyst asserted that "instead of charging customers for traffic, Verizon are turning to charging advertisers for eyeballs." The deal is also in line with Starboard Value LP's (investor of Yahoo) intention to merge AOL Inc. with Yahoo to reduce costs amounting to USD 1bn and to combine AOL's advertising technology and Yahoo's strong content for mobile devices. Together with Verizon's insights on user data, another analyst said the merger could make the advertising inventory much more valuable for Verizon. ([Bloomberg](#))

European banks brace for downturn with more cost cuts

Jul 24. Due to lower interest rates, Brexit, and the latest stress test results, European banks, which have already cut thousands of jobs, will have another round of cost-cutting. In addition to a 30% reduction in the 70 largest European banks' 2016 earnings per share forecasts, a Berenberg analyst stated that the current estimates of a 23% increase in average earnings of the European banks in 2017 should also be revised downwards. With Italy's banks showing troubling signs, analysts will be closely following the results of the latest European stress tests set to be released on Friday. European banks are expected at best to report a modest rebound in fixed income trading income in light of the sluggish growth in investment banking in the 2nd quarter as reported by big US banks. ([FT](#))

Draghi backs public bailout of Italy's ailing banks

Jul 21. European Central Bank President Mario Draghi backed a public bailout of Italy's troubled banks in "exceptional circumstances". The remark helped to alleviate concerns about Italian lenders, which suffer from piling bad debts and whose shares have been tumbling since the British referendum to leave the EU. European bank stocks, led by Italian banks, rallied after Draghi described the public bailout as a "very useful" way to help banks to get rid their books of non-performing loans. However, EU officials and Italian prime minister Matteo Renzi have yet to reach a consensus on the public bailout of Italian banks. ([FT](#))

IMF cuts 2016 global economic growth outlook after Brexit

Jul 19. The International Monetary Fund downgraded its forecast on global economic growth as the UK's decision to leave the EU weighs down on consumer confidence and investor sentiment. The IMF lowered its global growth estimate this year and the following year by 0.1%, placing 2016 growth estimate at 3.1%. The IMF also warned that other threats, such as geopolitical turmoil, rising protectionism, and terrorist attacks, could further weigh down on global growth. Though many markets have stabilized after Brexit, the IMF warned that the impacts will likely to play out over time. The fund's current outlook is rested on an assumption that the UK and the EU will preserve much of their key trade, finance and economic relationship. ([WSJ](#))

Woolworths soars most since 1997 on Banducci's planned overhaul ([Bloomberg](#))**C&J Energy Services files for bankruptcy ([WSJ](#))****Regulatory Updates****ESMA fines Fitch Ratings Limited EUR 1.28mn**

Jul 21. Fitch Ratings was fined EUR 1.38mn by the European Securities and Markets Authority (ESMA) for a series of violations of the Credit Rating Agencies (CRA) Regulation. According to ESMA, senior analysts in Fitch had transmitted information about impending rating actions on sovereign ratings to senior persons in a parent company of Fitch before the slated public release. In addition, ESMA had also uncovered that Fitch failed to introduce proper internal controls that would ensure a rated entity would have the minimum time to reply to a rating action prior to the public announcement. ([ESMA](#))

Singapore seeks US Chapter 11 prowess in bankruptcy law reform

Jul 20. The Ministry of Law, in an effort to establish Singapore's position as a center for debt restructuring, had "broadly accepted" 17 recommendations following a yearlong review. This move comes amid rising bond default rates globally with the number of bond defaults registering at 100 through July 2015 as compared to 62 defaults at this time last year; the worst since the aftermath of the collapse of Lehman Brothers Holdings according to S&P Global Ratings. The recommendations include offering automatic stay of legal and enforcement actions for debtors, creating a bench of specialist judges for its bankruptcy court and increasing rescue-financing capital by enticing distressed-debt funds and private equity firms to operate in Singapore. ([Straits Times](#))

India introduces first bankruptcy law ([BBC](#))**EBA consults on the appropriate basis for the target level of resolution financing arrangements ([EBA](#))**