



CUBEWEALTH

SMITH & WESSON BRANDS EQUITY REPORT

SEPTEMBER 13TH, 2020

SMITH & WESSON

BY THE NUMBERS

TICKER: SWBI

PRICE: \$17.03



Smith & Wesson®

Smith & Wesson Brands, Inc. designs, manufactures, and sells firearms worldwide.

The company offers firearms products, such as revolvers and pistols; modern sporting rifles, bolt action rifles, and muzzleloaders; handcuffs; suppressors; and other firearm-related products under the Smith & Wesson, M&P, Performance

Center, Thompson/Center Arms, and Gemtech brands. It also provides manufacturing services, which include forging, heat treating, rapid prototyping, tooling, finishing, plating, machining, and custom plastic injection molding to other businesses under the Smith & Wesson and Smith & Wesson Precision Components brands; and sells parts purchased through third parties.

The company was formerly known as American Outdoor Brands Corporation and changed its name to Smith & Wesson Brands, Inc. in June 2020. Smith & Wesson Brands, Inc. was founded in 1852 and is based in Springfield, Massachusetts.

1.1%

**DIVIDEND
YIELD**

+127%

**YTD
RETURN**

\$950M

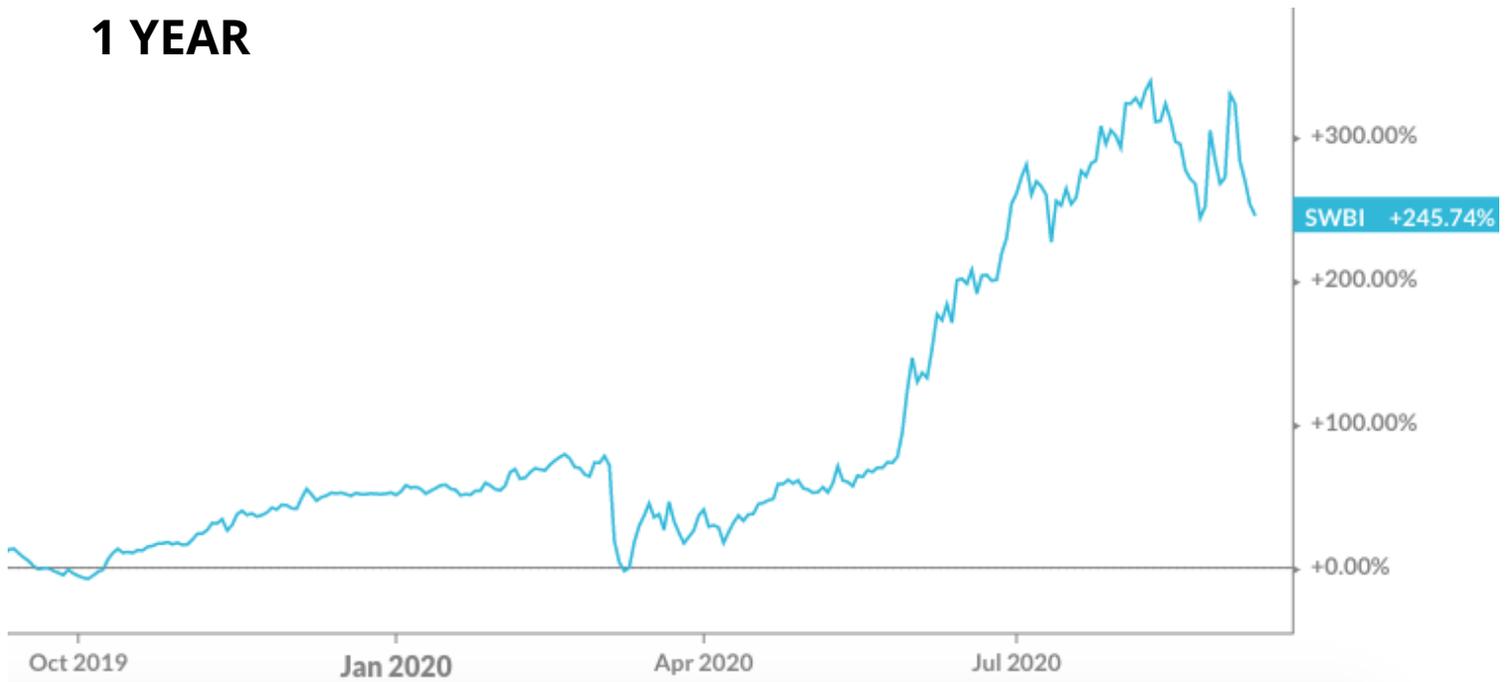
**MARKET
CAP**

SWBI



SHARE PRICE PERFORMANCE

1 YEAR



3-YEAR



ANALYSIS

Smith & Wesson is a brand many of us have heard of at some point in our lives. The company dates back to the 1800's and comes with a long and interesting history. For example, the first American firearm capable of firing a fully self-contained cartridge was manufactured by Smith & Wesson in 1852. The repeating pistol fired as quickly as the shooter could operate the lever and it was dubbed "The Volcanic," since the rapid-fire sequence appeared to have the force of an erupting volcano.

Then in the early 1880s, D.B. Wesson and his son, Joseph, began developing a revolver that didn't have an external hammer. The Safety Hammerless, which debuted in 1887, was the world's first double action concealed hammer revolver.

Moving along to 1955, the first American-made double action auto-loading pistol, the Model 39, was introduced. In 1968, the Illinois State Police adopted it and the Model 39 became the first 9mm Double Action auto-loading pistol ever used by any state law enforcement agency in the United States.

Fast forward to 2020, SWBI is changing things up but in a different way. As of last month, they officially completed the spin off of American Outdoor Brands, Inc. and it is now an independent, publicly traded company on the NASDAQ stock market under the symbol "AOUT."

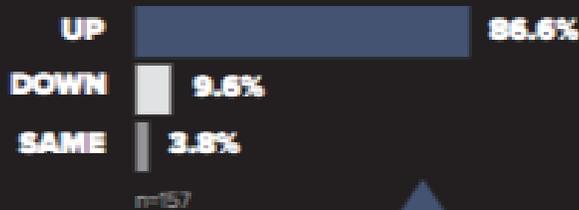
What this leaves SWBI investors with is a pure-play company in the firearms space at a time when Americans are buying up guns like never before due to countrywide increase in lootings, theft, "defund the police" movements, and worries that their 2nd Amendment right to bear arms is in jeopardy.

Let's dive into the firearms market right now:

- Gun sales surged 135% year-over-year in July to about 2 million and have already matched all of last year, according to a report released earlier this week by research consultancy Small Arms Analytics and Forecasting. Sales were up 145% in June, 80% in May and 71% in April.
- A Brookings Institute report based on data from the National Instant Criminal Background Check System found, "In just the first six months of 2020, approximately 19 million firearms have been sold, representing more than one firearm for every 20 Americans."
- Gun sales dramatically rose in response to the George Floyd protests, resulting in 150,000 per day on June 2 and 3.
- Women are part of this national gun buying spree, comprising 40% of first-time owners, according to NSSF, the trade association for the firearms industry.
- The Federal Bureau of Investigation processed 7.8 million background checks for gun purchases from March to June, according to National Shooting Sports Foundation, a firearms industry trade group.
- FBI showed that more than 3.6 million firearm background checks were conducted, making July the third-highest month on record.

Below are some infographics to further highlight the demand of firearms.

TOTAL SALES OF FIREARMS
during the first half of 2020
versus your total sales of
Firearms during first half of 2019.

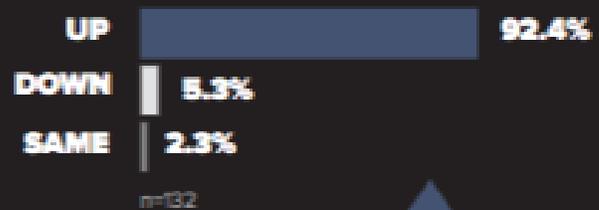


87%

OF RETAILERS

saw an increase in firearm sales during the first half of 2020.

TOTAL SALES OF AMMUNITION
during the first half of 2020 versus
your total sales of Ammunition
during first half of 2019.



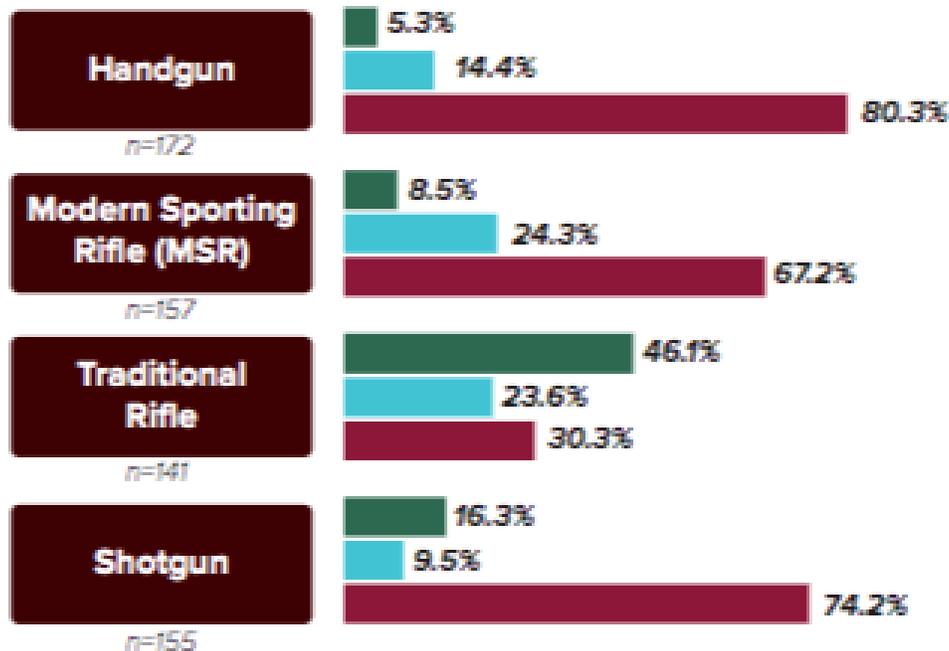
92%

OF RETAILERS

saw an increase in ammunition sales during the first half of 2020.

(First time gun buyers January - April 2020)

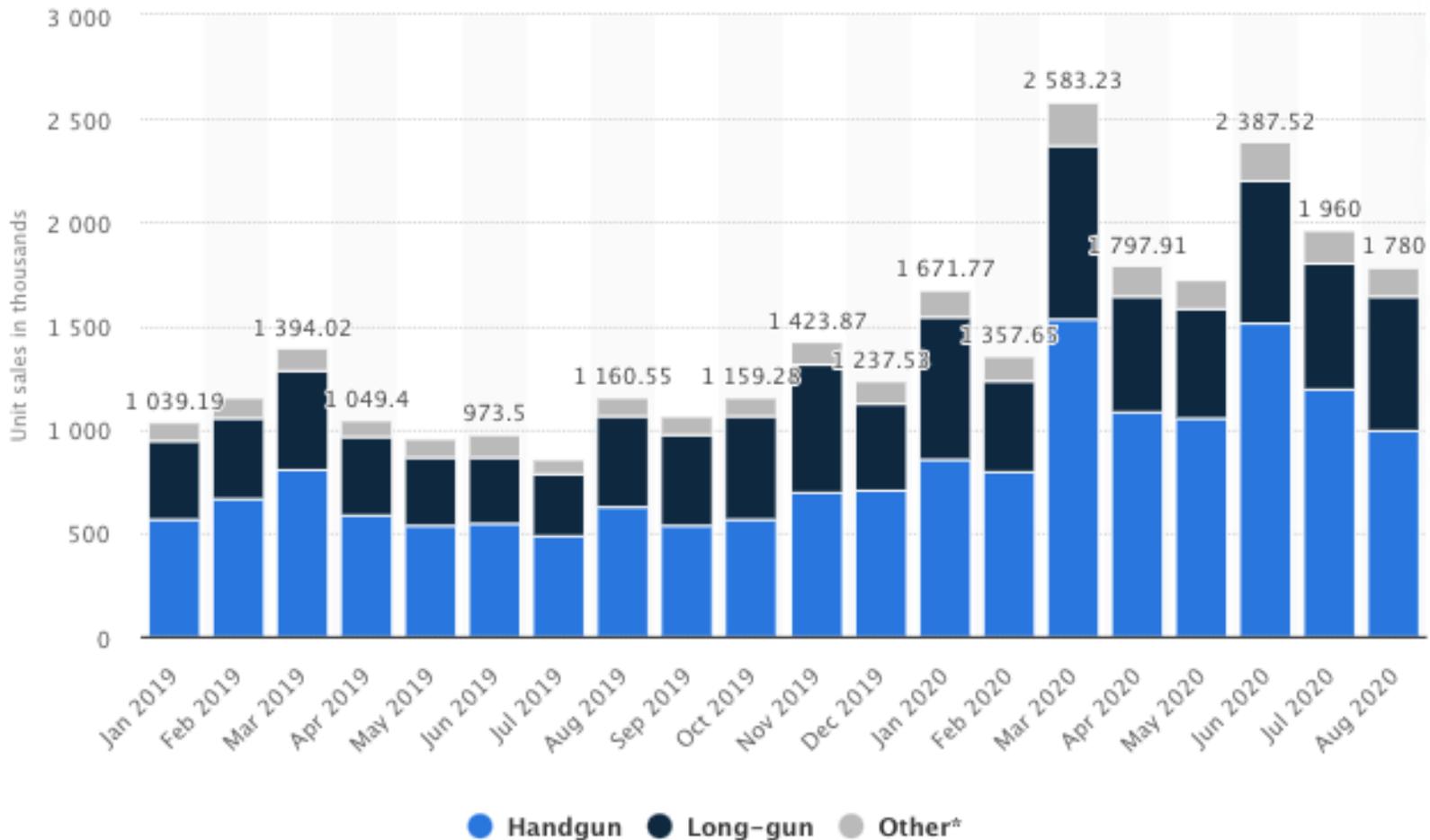
■ *Hunting* ■ *Target Shooting* ■ *Personal Protection*



NSSF[®] *The Firearm Industry Trade Association*

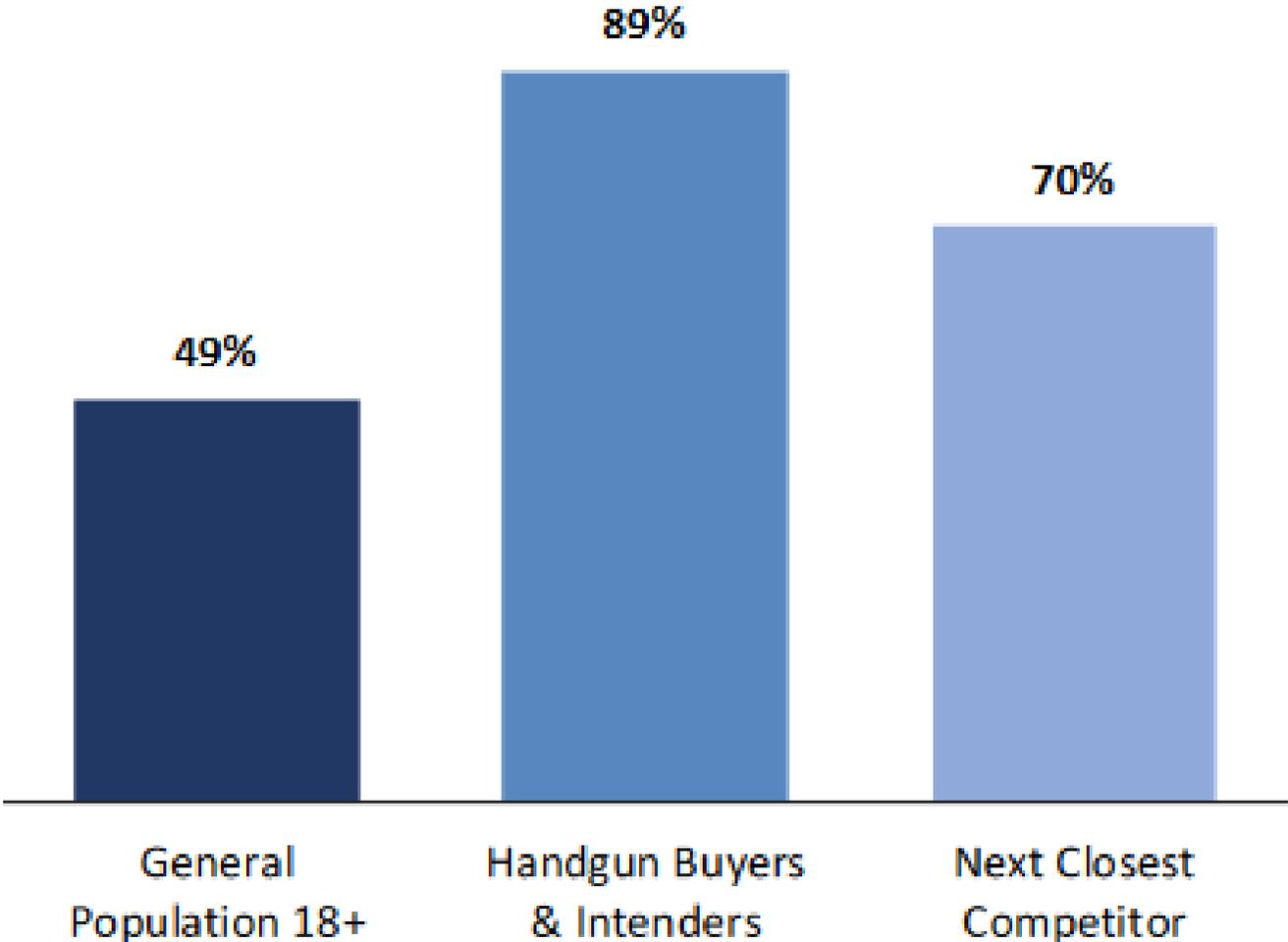
Below is a chart displaying monthly unit sales (in thousands) per category - handguns/long-run/other. This is not for SWBI, it is the overall firearms market.

March has currently seen the most purchases but volume continues to remain well above 2019.



As already mentioned, SWBI is one of the most recognized brands in the firearms space with 49% of the general population over the age of 18 knowing the brand. This is so important at a time like this because many first-time gun owners will prefer to purchase from a brand they are already familiar with.

SMITH & WESSON BRAND RECOGNITION



CUBE will now use this portion to discuss the discounted free cash flow model we have created for SWBI.

- SWBI Beta: 0.75
- 30 YR Risk Free Rate: 1.40%
- Market Risk Premium: 6.5%
- Discount Rate: 6.3% +/- 0.25%
- Perpetual Growth Rate: 2.5% +/- 0.25%, as the number of background checks being conducted has increased at a 3% compound annual growth rate over the last 10 years
- Tax Rate: 21%

The highlighted yellow boxes indicate election years. CUBE expects growth in revenues to come in at 34% in 2020 but for SWBI its considered FY2021. The average firm that covers SWBI on the Street expects revenues of \$841M but we believe sales are growing much faster than expectations. For example, in Q1 FY21, revenues came in at \$278M beating expectations by \$73M so we believe the Street is far too conservative and the data above fully supports CUBE's thesis of a record year for SWBI with projected revenues of \$909M.

CUBE then expects revenues to taper off in FY2022 by 25%. There are three reasons for this:

1. CUBE believes President Trump will be reelected and thus gun sales will slow down as people feel their second amendment rights are not in as much danger
2. SWBI spun off their Outdoors business which generates roughly 25% of their sales.
3. We believe the firearms business will still have a good year but do anticipate many people that have applied for their licenses to decide not to purchase a gun if the riots and looting cool off post-election.

There are tons of variables that can shake out and SWBI is a very difficult company to model because their revenues are wildly inconsistent. We expect solid 20-25% growth in election years with 2020 being an outlier due to above average tension between political parties, "defund the police" concerns, police brutality awareness, and sheer pandemonium caused by stay-at-home orders and increased unemployment from COVID19. Put simply, 2020 is the perfect storm for SWBI. We expect each year that follows an election to record negative Y/Y growth.

We also believe their free cash flow margins will see a boost during election years similar to how we have already seen it in Q1. We are holding that free cash flow yield steady for the rest of FY2021.

You will notice that CUBE has dropped the free cash flow yield in non-election years going forward vs. FY2020 (2019) because their Outdoors business actually contributed fairly well with 40-45% gross margins. The Q1 report is the last time the Outdoors business will be included in their financials.

As a result, CUBE arrives at the following valuations for the company:

Base Case Price Target: \$22.89

Best Case Price Target: \$26.24

Weak Case Price Target: \$20.62

At the current price of \$17.03, we think shares are valued about 30% below its true intrinsic value. In the case that Biden/Harris are elected, it's a toss up if SWBI would be worth more. CUBE sees a scenario in which there is larger more immediate bump in 2021 (FY22) revenues but eventually tapers out due to a potential increase gun control. This is also why CUBE believes shares are so volatile. There are so many variables that will ultimately change the true worth of SWBI.

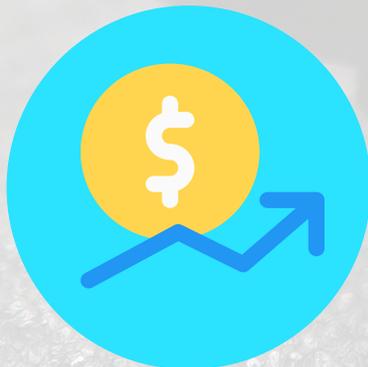
CUBE'S TOP PROS FOR SWBI



MARKET LEADER
& RECOGNIZED
BRAND



ZERO NET DEBT

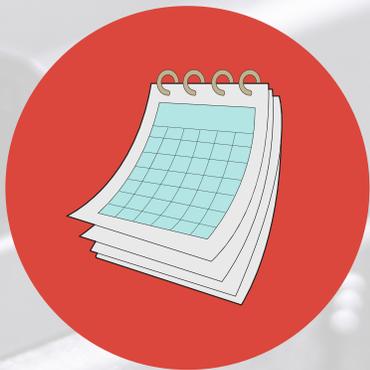


ATTRACTIVE
VALUATION

CUBE'S TOP CONS FOR SWBI



INCONSISTENT &
CYCLICAL
REVENUES



TOUGH Y/Y
COMPS AFTER
ELECTION



LACK OF
INTERNATIONAL
BUSINESS

FINANCIAL STATEMENTS

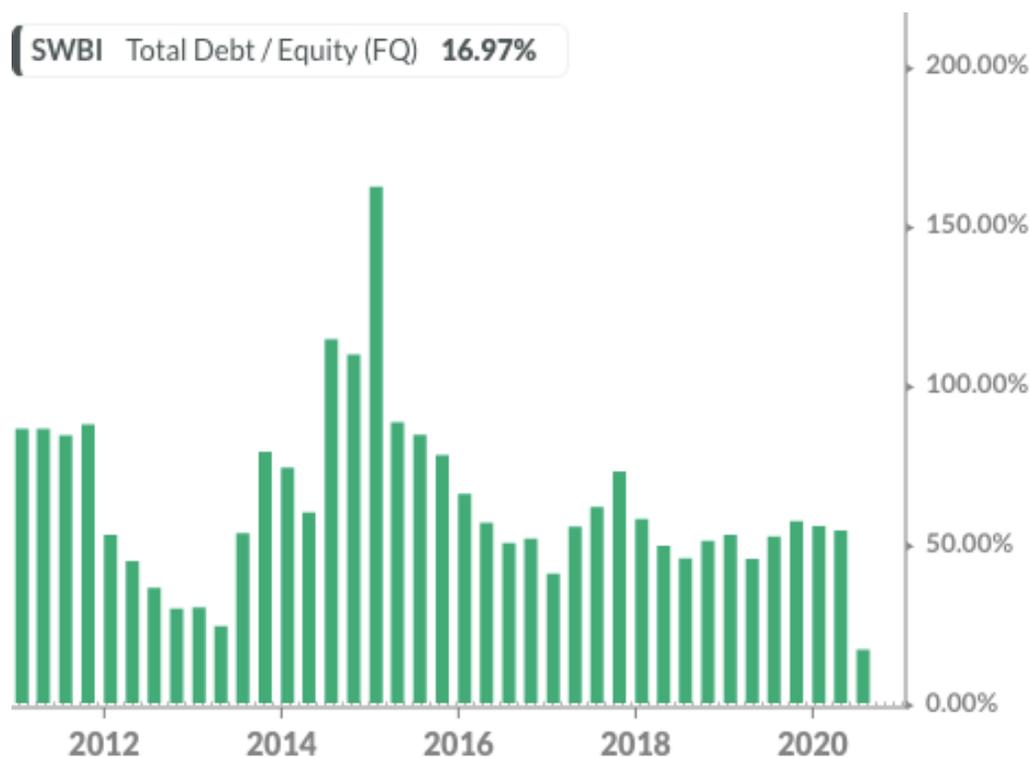
BALANCE SHEET

	As of:	
	July 31, 2020	April 30, 2020
(In thousands, except par value and share data)		
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 65,271	\$ 125,398
Accounts receivable, net of allowances for credit losses of \$1,411 on July 31, 2020 and \$1,438 on April 30, 2020	101,358	93,433
Inventories	149,567	164,191
Prepaid expenses and other current assets	11,015	8,838
Income tax receivable	656	1,595
Total current assets	<u>327,867</u>	<u>393,455</u>
Property, plant, and equipment, net	156,785	157,417
Intangibles, net	69,842	73,754
Goodwill	83,605	83,605
Deferred income taxes	2,396	2,396
Other assets	17,674	18,334
	<u>\$ 658,169</u>	<u>\$ 728,961</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	\$ 53,829	\$ 39,196
Accrued expenses and deferred revenue	49,987	64,602
Accrued payroll and incentives	13,241	14,623
Accrued income taxes	18,905	5,503
Accrued profit sharing	5,877	2,414
Accrued warranty	3,462	3,633
Total current liabilities	<u>145,301</u>	<u>129,971</u>
Notes and loans payable, net of current portion	24,311	159,171
Finance lease payable, net of current portion	39,610	39,873
Other non-current liabilities	11,882	12,828
Total liabilities	<u>221,104</u>	<u>341,843</u>
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Preferred stock, \$.001 par value, 20,000,000 shares authorized, no shares issued or outstanding	—	—
Common stock, \$.001 par value, 100,000,000 shares authorized, 73,864,745 issued and 55,697,883 shares outstanding on July 31, 2020 and 73,526,790 shares issued and 55,359,928 shares outstanding on April 30, 2020	74	74
Additional paid-in capital	269,192	267,630
Retained earnings	390,101	341,716
Accumulated other comprehensive income	73	73
Treasury stock, at cost (18,166,862 shares on July 31, 2020 and April 30, 2020)	(222,375)	(222,375)
Total stockholders' equity	<u>437,065</u>	<u>387,118</u>
	<u>\$ 658,169</u>	<u>\$ 728,961</u>

SWBI was able to generate operating cash flow of \$83.5M during the quarter, which, combined with their cash on hand, allowed them to pay down \$135.0M on their revolving line of credit and end the quarter with zero net debt.

As you can see in the chart below, total debt to equity has fallen from over 54.3% to just shy of 17%.

Cash on hand is now \$65.2M after paying down their debt and SWBI's board has authorized to declare a regular, quarterly cash dividend of \$0.05 per share. The first quarterly dividend will be payable on October 1, 2020 to shareholders of record as of the market close on September 17, 2020.



FINANCIAL STATEMENTS

INCOME STATEMENT

	For the Three Months Ended July 31,	
	2020	2019
	(In thousands, except per share data)	
Net sales	\$ 277,965	\$ 123,665
Cost of sales	161,199	75,811
Gross profit	116,766	47,854
Operating expenses:		
Research and development	2,965	3,229
Selling, marketing, and distribution	19,269	16,773
General and administrative	29,080	26,709
Total operating expenses	51,314	46,711
Operating income	65,452	1,143
Other (expense)/income, net:		
Other income/(expense), net	151	5
Interest expense, net	(1,316)	(2,627)
Total other (expense)/income, net	(1,165)	(2,622)
Income/(loss) from operations before income taxes	64,287	(1,479)
Income tax expense	15,902	629
Net income/(loss)	48,385	(2,108)
Comprehensive income/(loss)		
Change in unrealized loss on interest rate swap	—	(420)
Other comprehensive loss, before income taxes	—	(420)
Income tax benefit on other comprehensive loss	—	92
Other comprehensive loss, net of tax	—	(328)
Comprehensive income/(loss):	\$ 48,385	\$ (2,436)
Net income/(loss) per share:		
Basic	\$ 0.87	\$ (0.04)
Diluted	\$ 0.86	\$ (0.04)
Weighted average number of common shares outstanding:		
Basic	55,494	54,783
Diluted	56,277	54,783

- Quarterly net sales were \$278.0M compared with \$123.7M for the first quarter last year, an increase of 124.8%.
- Firearms segment gross sales were \$229.9M, which included \$1.0M of inter-segment revenue, an increase of \$134.4M, or 140.9%, over the comparable quarter last year.
- Outdoor Products & Accessories segment gross sales were \$50.6 million, which included \$1.5M of inter-segment revenue, an increase of \$17.4M, or 52.3%, over the comparable quarter last year - this is the last time this will be recorded for SWBI due to spin off
- Gross margin for the quarter was 42.0% compared with 38.7% for the comparable quarter last year.
- Quarterly GAAP net income was \$48.4M, or \$0.86 per diluted share, compared with a GAAP net loss of \$(2.1M), or \$(0.04) per diluted share, for the comparable quarter last year.
- Quarterly non-GAAP net income was \$54.9M, or \$0.97 per diluted share, compared with \$1.7M, or \$0.03 per diluted share, for the comparable quarter last year. GAAP to non-GAAP adjustments for net income exclude costs related to the spin-off of the Outdoor Products & Accessories segment, COVID-19 related expenses, and other costs.
- Quarterly non-GAAP Adjusted EBITDAS was \$84.2M, or 30.3% of net sales, compared with \$17.5M, or 14.1% of net sales, for the comparable quarter last year.

Gross margin for the quarter ended July 31, 2020 for their Firearm segment increased 310 basis points over the comparable quarter last year, primarily because of lower promotional product spending, favorable manufacturing fixed cost absorption, and favorable price increases.

Long-guns experienced the largest revenue growth at 224.4% Y/Y across shipments of 112,000 units. Handguns experienced the largest volume growth at 109.8% to 472,000 units during the quarter, up from 225,000 in the same period last year.

	2020	2019	\$ Change	% Change
Handguns	\$ 165,169	\$ 69,710	\$ 95,459	136.9%
Long Guns	53,847	16,600	37,247	224.4%
Other Products & Services	10,868	9,127	1,741	19.1%
Total Firearm Revenue	\$ 229,884	\$ 95,437	\$ 134,447	140.9%
Cost of sales	137,461	60,039	77,422	129.0%
Gross profit	\$ 92,423	\$ 35,398	\$ 57,025	161.1%
% of net sales (gross margin)	40.2%	37.1%		

The following table sets forth certain information regarding firearm units shipped by trade channel for the three months ended July 31, 2020 and 2019 (units in thousands):

<u>Total Units Shipped</u>	2020	2019	# Change	% Change
Handguns	472	225	247	109.8%
Long Guns	112	60	52	86.7%
<u>Sporting Goods Channel Units Shipped</u>	2020	2019	# Change	% Change
Handguns	441	199	242	121.6%
Long Guns	108	57	51	89.5%
<u>Professional Channel Units Shipped</u>	2020	2019	# Change	% Change
Handguns	31	26	5	19.2%
Long Guns	4	3	1	33.3%

FINANCIAL STATEMENTS

CASH FLOW

	For the Three Months Ended July 31,	
	2020	2019
	(In thousands)	
Cash flows from operating activities:		
Net income/(loss)	\$ 48,385	\$ (2,108)
Adjustments to reconcile net income/(loss) to net cash provided by/(used in) operating activities:		
Depreciation and amortization	12,888	14,346
Loss/(gain) on sale/disposition of assets	3	—
Provision for losses on notes and accounts receivable	136	634
Stock-based compensation expense	1,041	1,588
Changes in operating assets and liabilities:		
Accounts receivable	(6,811)	14,031
Inventories	14,624	(31,678)
Prepaid expenses and other current assets	(2,177)	(2,822)
Income taxes	14,341	397
Accounts payable	14,061	(6,015)
Accrued payroll and incentives	(1,382)	(10,875)
Accrued profit sharing	3,463	686
Accrued expenses and deferred revenue	(14,640)	(6,675)
Accrued warranty	(171)	(612)
Other assets	660	428
Other non-current liabilities	(946)	(463)
Net cash provided by/(used in) operating activities	<u>83,475</u>	<u>(29,138)</u>
Cash flows from investing activities:		
Payments to acquire patents and software	(292)	(123)
Payments to acquire property and equipment	(7,343)	(3,695)
Net cash used in investing activities	<u>(7,635)</u>	<u>(3,818)</u>
Cash flows from financing activities:		
Proceeds from loans and notes payable	—	25,000
Payments on finance lease obligation	(238)	(214)
Payments on notes and loans payable	(135,000)	(1,575)
Proceeds from exercise of options to acquire common stock	268	—
Payment of employee withholding tax related to restricted stock units	(997)	(538)
Net cash (used in)/provided by financing activities	<u>(135,967)</u>	<u>22,673</u>
Net decrease in cash and cash equivalents	(60,127)	(10,283)
Cash and cash equivalents, beginning of period	125,398	41,015
Cash and cash equivalents, end of period	<u>\$ 65,271</u>	<u>\$ 30,732</u>
Supplemental disclosure of cash flow information		
Cash paid for:		
Interest	\$ 1,556	\$ 1,690
Income taxes	\$ 1,689	\$ 235

Cash provided by operating activities was \$83.5M for the three months ended July 31, 2020 compared with a cash usage in the prior year comparable quarter due to an incremental \$50.5M increase in net income, an incremental \$46.3M decrease in inventory because of increased shipments to meet consumer demand, and an incremental \$20.1M increase in accounts payable due to increased manufacturing purchases and timing of payments. These favorable impacts were partially offset by an incremental \$20.8M increase in accounts receivable due to timing of shipments and an incremental \$8.0M decrease in accrued expenses primarily due to lower promotional product discount accruals. SWBI expects firearm inventory balances to remain relatively flat throughout the next fiscal quarter.

Cash used in investing activities increased \$3.8M for the three months ended July 31, 2020 over the prior year comparable period. They recorded capital expenditures of \$7.3M for the three months ended July 31, 2020, \$3.6M higher than the prior year comparable period. They currently expect to spend between \$30M-\$35M on capital expenditures in fiscal 2021, an increase of \$16.1M-\$21.1M, as compared with \$13.9M in capital expenditures in fiscal 2020.

Cash used in financing activities was \$136.0M for the three months ended July 31, 2020 compared with cash provided by financing activities of \$22.7M for the three months ended July 31, 2019. Cash used in financing activities during the three months ended July 31, 2020 was primarily a result of \$135.0M of payments on the credit facility.

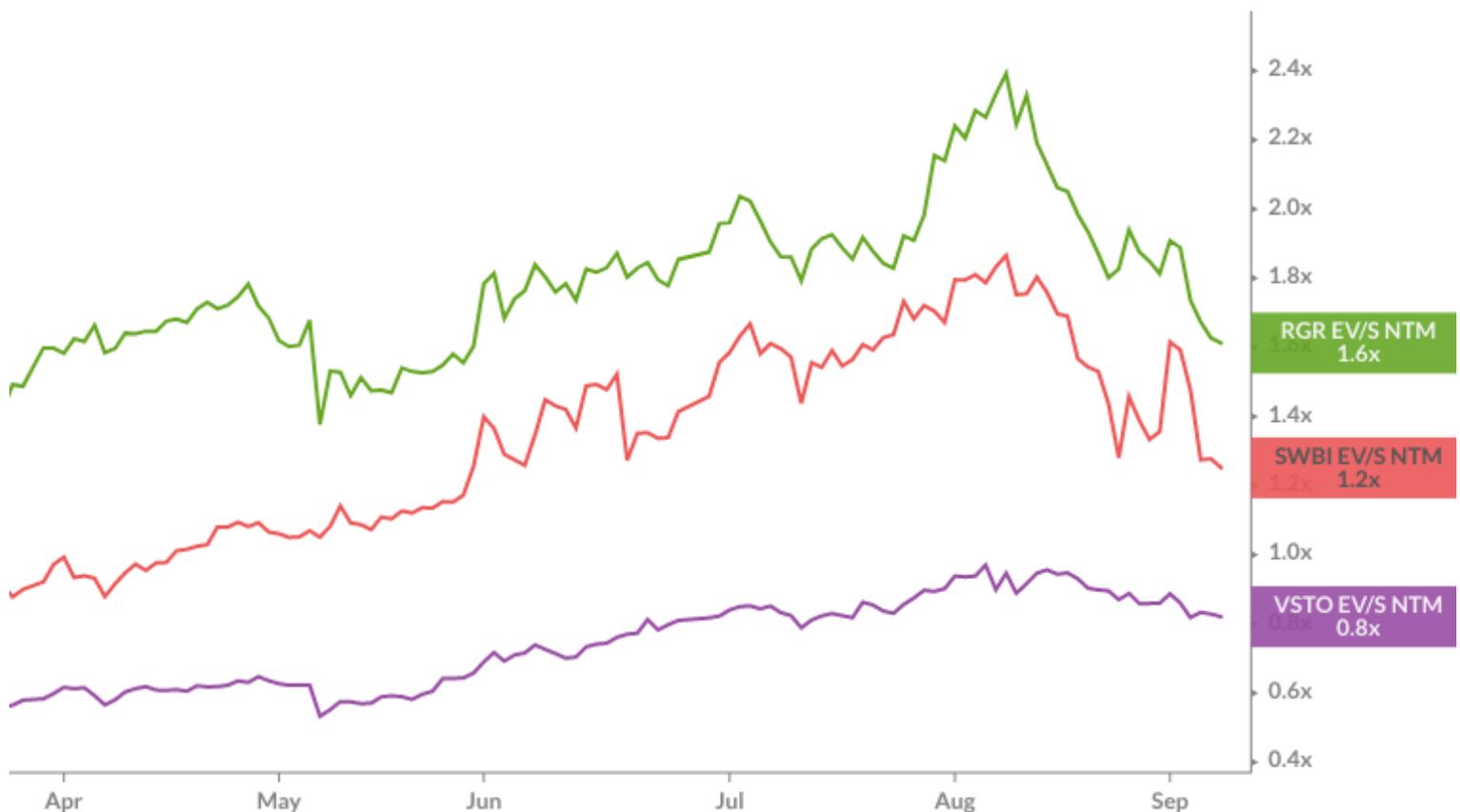
Free cash flow was $\$83.5\text{M} - \$7.3\text{M (capex)} = \$76.2\text{M}$



SWBI FUNDAMENTALS

We are going to compare SWBI to Sturm Ruger & Co (RGR) and Vista Outdoor (VSTO).

SWBI is at the middle point at a pretty attractive 1.2x forward sales. Keep in mind, these are not companies that are going to trade for anything over 3x sales. The highest on record SWBI has ever trades on forward to sales basis was 2.9x back in 2007. Its lowest ever recording was 0.5x sales back in October 2011.





SWBI FUNDAMENTALS

On an enterprise value to EBITDA basis, SWBI slides to the bottom and is the cheapest at 5.1x. This is extremely attractive but, once again please keep in mind, these companies are cyclical stocks and will not trade at sky high multiples. On average, SWBI will trade between 6-9x so we do see shares being a bit undervalued here historically and also in comparison to RGR and VSTO.





SWBI FUNDAMENTALS

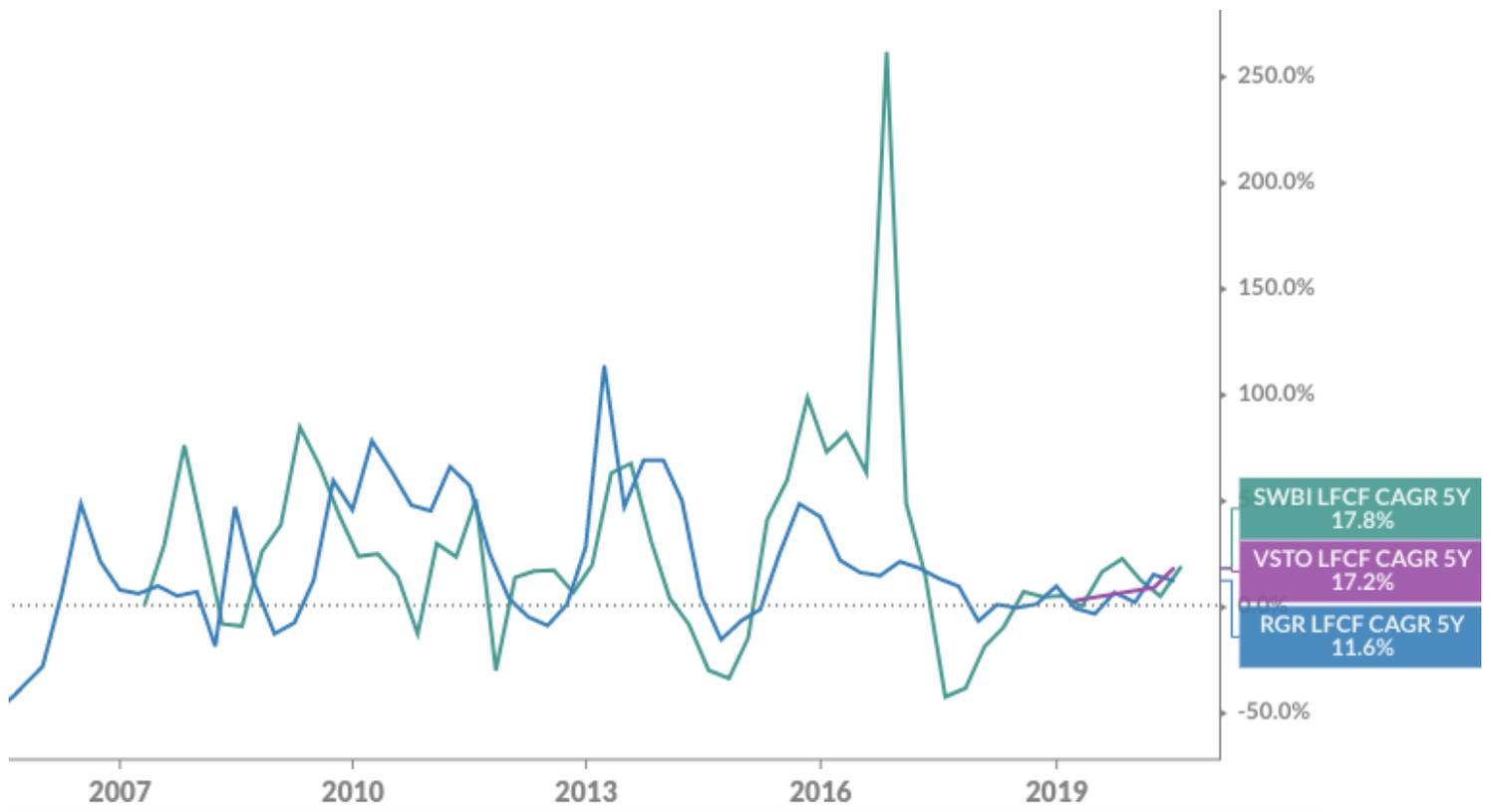
Lastly, on a price to earnings standpoint, SWBI is also trading at a very low P/E of 8.2x which is considerably lower than its peers - especially that of RGR. On record, SWBI's lowest ever forward P/E was 6.5x back in the 2008 financial crisis meltdown. Keep in mind, this multiple is extremely low and skewed at the moment because of rocketing sales and earnings that are most likely going to come back down to normalized levels in 2021+. Regardless, this is historically very low for SWBI.





SWBI FUNDAMENTALS

Despite carrying lower multiples, SWBI is actually growing their levered free cash flow at a faster rate than their peers over the last 5 years. SWBI has grown their free cash flow at a 17.8% CAGR while VSTO has grown theirs by 17.2% and RGR has grown by 11.6%.





SWBI TECH ANALYSIS





TECH ANALYSIS SUMMARY

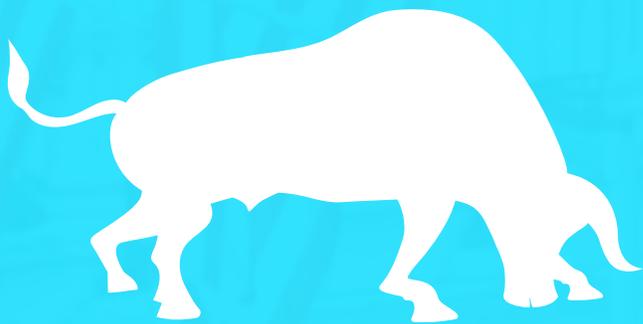
Looking at the charts, SWBI has support at \$16.76 on the weekly R3 fibonacci level. In the case that this level does break, shares should retreat rather quickly to the daily S1 fibonacci level (bottom image) of \$15.57.



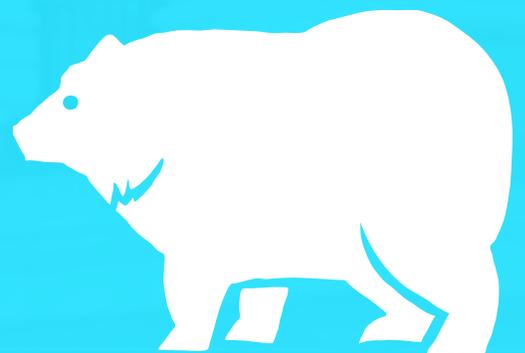
Next major resistance levels are the 50 day moving average of \$18.17 and the daily pivot point of \$18.46.

At this point in time, CUBE is favoring more short-term downside for SWBI with a visit to the mid \$15s due to fading volume, multiple rejections of the 50DMA, and a broken upward channel.

BULLISH OR BEARISH?



VS.



**MORE BULLISH
(POSITIVE)**

**MORE BEARISH
(NEGATIVE)**





SWBI CONCLUSION

Overall, CUBE is bullish on SWBI - even after the run it had from \$5 in March to \$17 here in September. We do not find it coincidental that the stock pulled back from the \$28 range as that's slightly above where we see SWBI's true intrinsic value.

We are a big fan of the company's decision to drastically reduce their debt, start up their dividend, and dial in on their true business identity. One of the main reasons CUBE is not giving this a 5/5 CUBE rating is because there are many variables that can change in an instant and shift SWBI from a great buy to a strong sell. Examples include public perception of guns, change in crime rates, elections, increased competition, inventory management, delayed registrations, and so on. Most companies CUBE does research on involve companies with consistent revenues, and in many cases subscription-based revenues, that are extremely predictable but that is simply not the case for SWBI. There is a built in risk of cyclicity and SWBI has shown twice in its history that it cannot sustain its large gains - back in 2007 when it ran from \$1 to \$16 only to retreat to \$1.50 the following year and in 2014 when it ran from \$7 to \$23 only to pull back to \$7 the next year. With this in mind, we still believe SWBI is undervalued but pay close attention to the narrative as it can alter their future cash flows drastically.

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