

INVESTMENT THESIS

SHORT: Smith and Wesson Holding Company (SWHC: \$4.81)

SHORT: Sturm Ruger and Co. (RGR, \$10.63)

Company	Smith and Wesson Holding Corp.	FY1 PE (Consensus)	25.3	YTD % Change	111.9%
Ticker	SWHC	FY2 PE (Consensus)	13.0	52 Week High	7.52
Stock Price	\$4.81	FY1 EV/EBITDA (PAA)	6.8x	52 Week Low	1.53
Mkt Cap	259	FY2 EV/EBITDA (PAA)	7.2x	200-Day	3.87
Enterprise Value	288	FCF Yield FY1 (PAA)	12.2%	50-Day	5.84
Net Debt	29	ROE	15.6%	RSI	40.74
Credit Ratings	N/A	Price/Book	3.0x	Avg. Daily Vol. (000s)	1370.0
Cash/Share	\$0.44	Dividend Yield	N/A		

Company	Sturm Ruger and Co.	FY1 PE (Consensus)	10.1	YTD % Change	78.1%
Ticker	RGR	FY2 PE (Consensus)	14.2	52 Week High	13.71
Stock Price	\$10.63	FY1 EV/EBITDA (PAA)	6.6x	52 Week Low	4.36
Mkt Cap	203	FY2 EV/EBITDA (PAA)	11.3x	200-Day	7.79
Enterprise Value	171	FCF Yield FY1 (PAA)	15.3%	50-Day	11.29
Net Debt	-33	ROE	12.2%	RSI	51.25
Credit Ratings	N/A	Price/Book	2.8x	Avg. Daily Vol. (000s)	400.6
Cash/Share	\$1.73	Dividend Yield	2.9%		

Investment Thesis Overview:

There have been few, if any bright spots in the consumer discretionary space over the past 12-18 months. The threat of job losses combined with an unprecedented shock to the net worth of most consumers has resulted in a seismic shift in consumer behavior. For the first time in decades, credit card debt outstanding is declining and the savings rate has increased. People are hunkering down – this is not a good time to be a company selling discretionary items at a high price point. There has been one bright spot in the consumer discretionary landscape – gun sales. According to the FBI, the number of background checks completed for gun purchases under the NICS system has increased 27.8% YOY through April, following a record amount in 4Q08. Keep in mind that a gun typically costs hundreds if not thousands of dollars. This is truly a stunning development.

What has been the cause of this surge in gun ownership? In a word: Obama. Fears of increased restrictions being placed on gun owners under the Obama administration have sparked a “run on guns” of sorts. 100% of the dealers we surveyed indicated that fears about gun control legislation have caused their sales to increase. Both SWHC and RGR, two gun manufacturers, have been the direct beneficiaries and their stocks have more than doubled off recent lows. Backlog for both companies is at record levels and manufacturing capacity along certain product lines is maxed out. However, we think the “Obama effect” has now peaked and we anticipate that it won’t be long before SWHC and RGR fare as well as other companies in the consumer discretionary space. Firearms have an extended useful life and there is no clear replacement cycle. In many respects, the strength in sales in the past six-months should only be viewed as demand from future periods that has now been “pulled forward”. Our thesis is based on the following :

1. **According to Compete.com, the number of unique visitors to the leading online gun dealers has declined almost 20% since December 2008 peaks. Additionally, information gleaned from Google, aka “the database of intentions” suggests the level of interest in purchasing a gun is declining.** We view internet traffic and Google keyword searches as two of the best indicators of current and future consumer activity. While the overall level of traffic to leading online gun dealers has increased dramatically YOY, the sequential trend paints a different picture. Additionally, keyword data from Google Trends shows a significant sequential decline over the past few months in searches for terms related to gun purchases. We think backlog will become the most meaningful metric for SWHC and RGR shares over the next few quarters. Internet traffic and Google trends data suggest backlog has peaked or could peak within the next quarter.
2. **Our proprietary survey of firearms dealers indicates that sales growth for SWHC and RGR could slow in the second half of the year.** Most dealers have witnessed significant sales growth as a result of the “Obama effect”. Pistols and ammunition remain in short supply. However, we were surprised to learn that more than 60% of the dealers we surveyed have witnessed an increase in inventories YOY. Additionally, re-order intentions imply a degree of caution among dealers.
3. **The stocks do not reflect the prospects that the Obama administration may eventually address gun control issues.** Many political pundits have been surprised that the Obama administration has avoided the gun control issue altogether for the most part. There has only been one meaningful piece of legislation proposed since the inauguration, H.R. 45 and that bill appears to have no momentum. Obama is a well established gun control advocate. We have no idea whether or not he plans to propose legislation this week, next month, next year, in his next term, or never. That being said, the impact of gun registration rules on demand (at least according to firearms dealers) could be significant. It is our view the stocks do not yet reflect substantial regulatory risk.

RISKS:

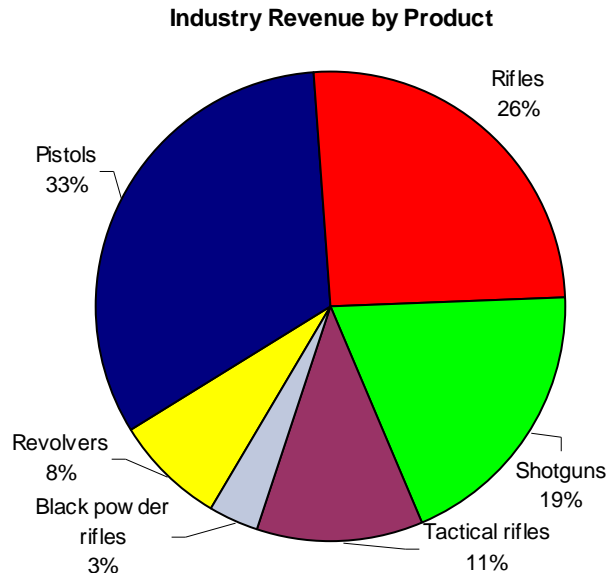
The risks to our investment thesis are the following:

1. Both SWHC and RGR have seen an unprecedented increase in backlog, which will result in strong revenue and EPS for at least 1-2 more quarters. Shares could rally to the extent the companies beat estimates and raise guidance.
2. A dramatic increase in the rate of crime could increase demand for guns on a sustained basis.
3. We might have underestimated the duration of the “Obama effect”, which could lead to revenue and EPS outperformance for SWHC and RGR beyond the next quarter or two.

BRIEF INDUSTRY AND COMPANY DESCRIPTION AND A LOOK AT THE TRADING HISTORY

According to Smith and Wesson, the domestic non-military gun market is approximately \$2.1 billion in size (although considerably larger this year). The industry can be divided into a few major product categories: revolvers, pistols, rifles, shotguns,

tactical rifles and black powder rifles. Pistols are the single largest product category. According to the U.S. Bureau of Alcohol, Tobacco and Firearms and Explosives, the industry increased at a compound annual growth rate of 8.3% from 2001 to 2006. Most people from within the industry think sales will typically track nominal GDP growth.



Source: Smith and Wesson Holding Company

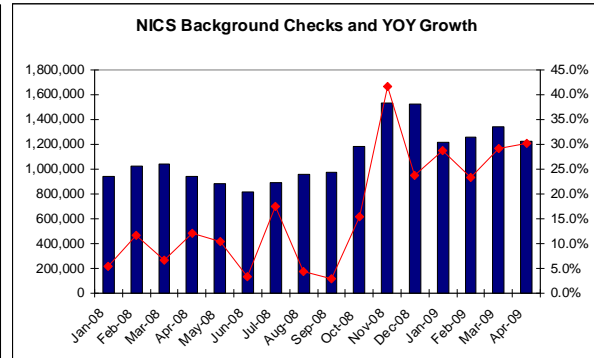
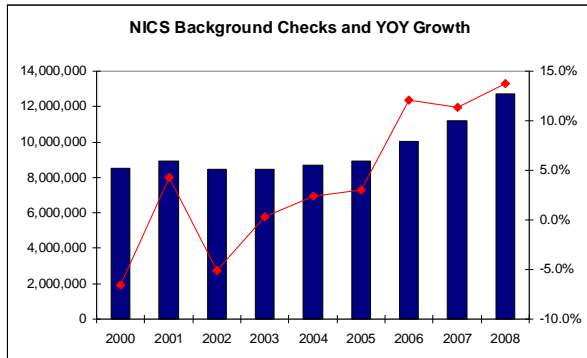
The Obama Effect: The 44th President's Most Effective Economic Stimulus Has Been for the Firearms Industry

There is no consistent way to track industry-wide gun sales. In lieu of that, one of the ways to gauge trends has been to look at the number of background checks conducted under the FBI's National Instant Criminal Background Check System (NICS), which was mandated by the Brady Bill in 1993. The NICS is a computerized background check system that checks available records on people who may be disqualified from purchasing firearms (those with a prior criminal record). Dealers are required, by law to submit information about the potential buyer of a gun before the firearm can be sold to that individual. In theory, the data should be a real time indicator of gun sales volume. However it does not capture activity that occurs outside of the dealer channel or in trades.

The two chart on the left below depicts the total number of NICS checks done annually from 2000-2008. For the most part, volume was flat until 2006-2007. For each of the past three years, the number of checks has increased in excess of 10%. We cannot speak to the exact factors that contributed to the increase in checks in 2006 and 2007, but we have a strong idea as to what drove the increase in 2008.

The chart on the right depicts the total number of NICS checks completed on a monthly basis from January 2008 through April 2009. Up until September 2008, the number of NICS checks had increased mid-to-high single digits, which would have been consistent with the trends witnessed in 2006 and 2007. However, starting in

October the overall number of checks surged and has been increasing in excess of 20% YOY since December 2008. In the past decade, there had only been one other month prior to this period in which there was an economic downturn and the number of NICS checks increased in excess of 20%, which was October 2001. It seems understandable that many Americans felt less secure in the months after 9/11, which created greater demand for firearms. We can only attribute the more recent surge in demand for guns to one factor – concerns about increased gun control under the Obama administration.



Some industry observers have likened this period to that of 1993/1994 when the Brady Bill and the Assault Weapons Ban were passed. During the period of debate over those bills, gun sales surged. Unfortunately, there isn't any good information as to how long the period of elevated sales lasted, nor how much demand declined after the laws were finally passed. To give you a better idea, here are some comments from SWHC's CEO, Michael Golden on their second quarter conference call:

"Back in the mid-90's there was a surge in firearm sales. I think that's what you're talking about. And it was a pretty interesting phenomenon. The surge lasted about 18-months and the years after the surge there was a little dip, but not much. It kind of came back right down to the trend line and just started back on the GDP growth level.

Source: Seeking Alpha

Let's compare this to what RGR's senior management had to say in a letter to shareholders dated 4/28/09.

*"While some of the demand for our products is due to our successful launch of new products over the past 18 months, a substantial portion of the current demand appears to be based on two concerns: that the change in Federal administrations might lead to a so-called assault weapons ban, and general concerns over personal security and property protection as the economy worsens. It is uncertain how long these concerns will drive demand, and whether the demand will taper off slowly, or decline precipitously. There is some precedent from 1994, when similar concerns drove up demand for a period of time. **It is important to note, however, that following the enactment of the 1994 assault weapons ban, demand declined significantly and quickly.***

I caution our Shareholders not to place undue reliance on the size of our backlog and current demand levels.”

Source: Sturm Ruger and Company, Inc.

In effect you have one management team talking up industry expectations, while another talks them down. Clearly 1994 is not a perfect proxy as to what is happening today, most notably because Obama and Congress have avoided the gun control issue thus far and we are in a vastly different economic environment than we were in 1994 and 1995. We remain skeptical of SWHC’s view that current demand trends are sustainable for 18-months.

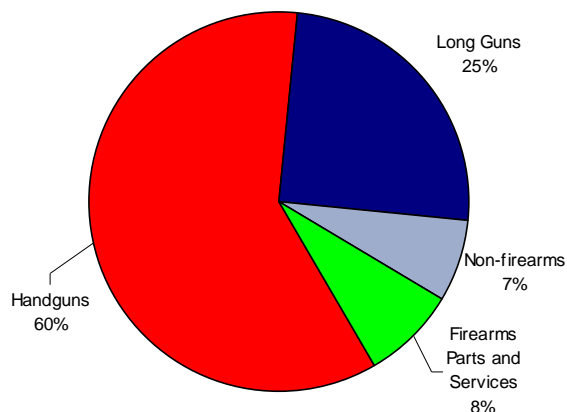
A Quick Look at Smith and Wesson and Sturm Ruger

Both SWHC and RGR have decades of operating history as gun manufacturers. Smith and Wesson was founded in 1852. The company now operates three manufacturing facilities in Springfield, MA, Houlton, ME and Rochester, NH. In January 2007, Smith and Wesson acquired Thompson/Center Arms Company, which significantly enhanced the company’s presence in the long gun market and made it a bigger player in the hunting channel. The company recently wrote-off all of the goodwill associated with that acquisition due to depressed demand for long guns and hunting rifles. In addition, to targeting the long gun market, SWHC has increased its focus on the law enforcement and military channels over the past few years.

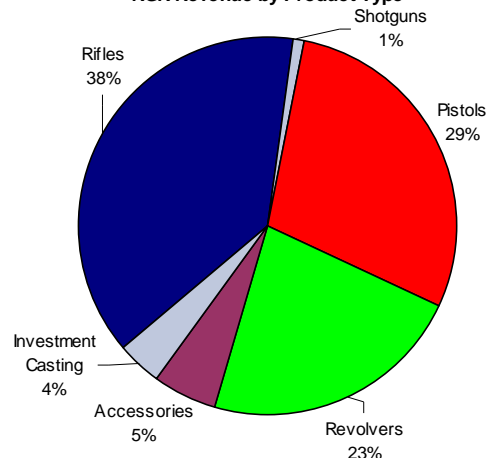
Sturm and Ruger was founded in 1949 and is best known for its pistols, such as the SR9. The company’s firearms are principally sold to the commercial sporting market. Sturm and Ruger operates two manufacturing facilities one in Newport, NH and the other in Prescott, AZ. Michael Fifer was appointed CEO of the company in September 2006, replacing William B. Ruger Jr., the son of the founder of the company.

The tables below outline SWHC’s and RGR’s sales by product line. Keep in mind that RGR sells primarily into the consumer channel.

SWHC Revenue Mix by Product Line

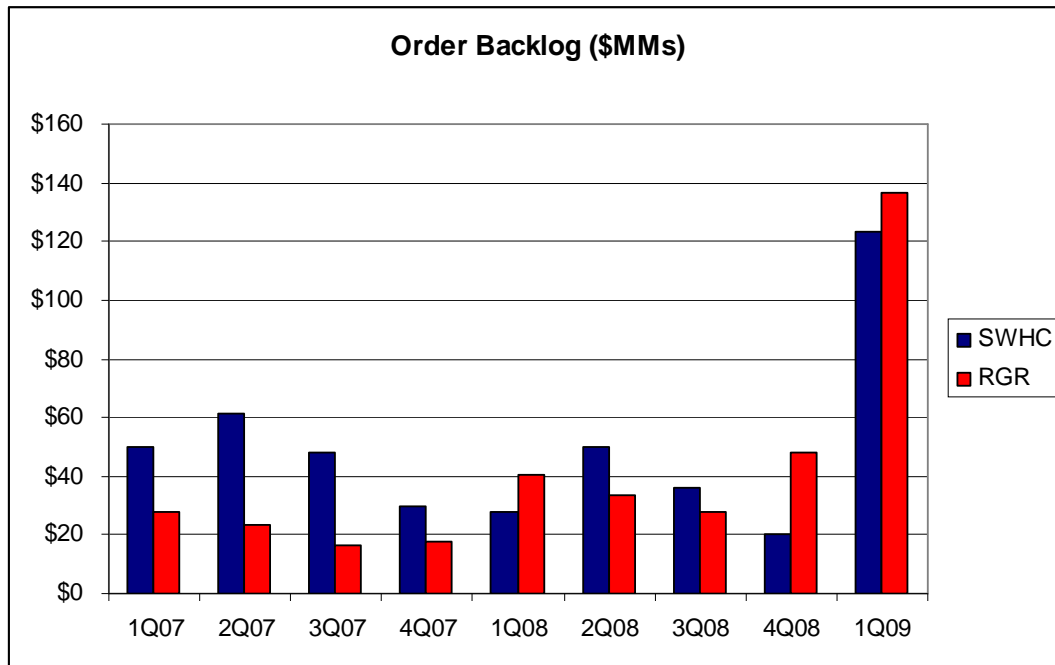


RGR Revenue by Product Type



Source: Company reports.

Both SWHC and RGR have benefited immensely from demand for firearms stoked by fears of imminent gun control laws. Backlog for both companies was at a record high in their recently reported quarter. In the first quarter of 2009, RGR received orders for 501,000 units, or more than 60% of its prior year total. SWHC's backlog was up approximately 345% YOY through its fiscal third quarter.

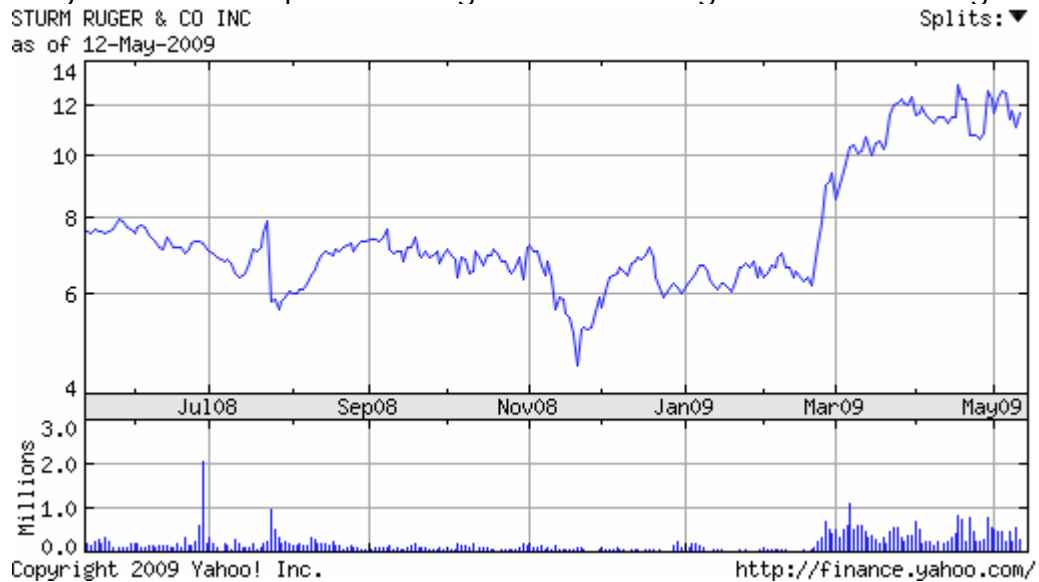


Trading Background:

SWHC shareholders have been on a wild-ride the past 2-3 years. The stock hit multi-year lows in November and has since more than doubled following the company's 2Q09 results.



RGR shares have been considerably less volatile over the past few years than those of SWHC, but they tend to trade in sympathy with each other. RGR shares rallied significantly after SWHC reported strong results and a big build in its backlog in March.



Short Dynamics and Insider Trading

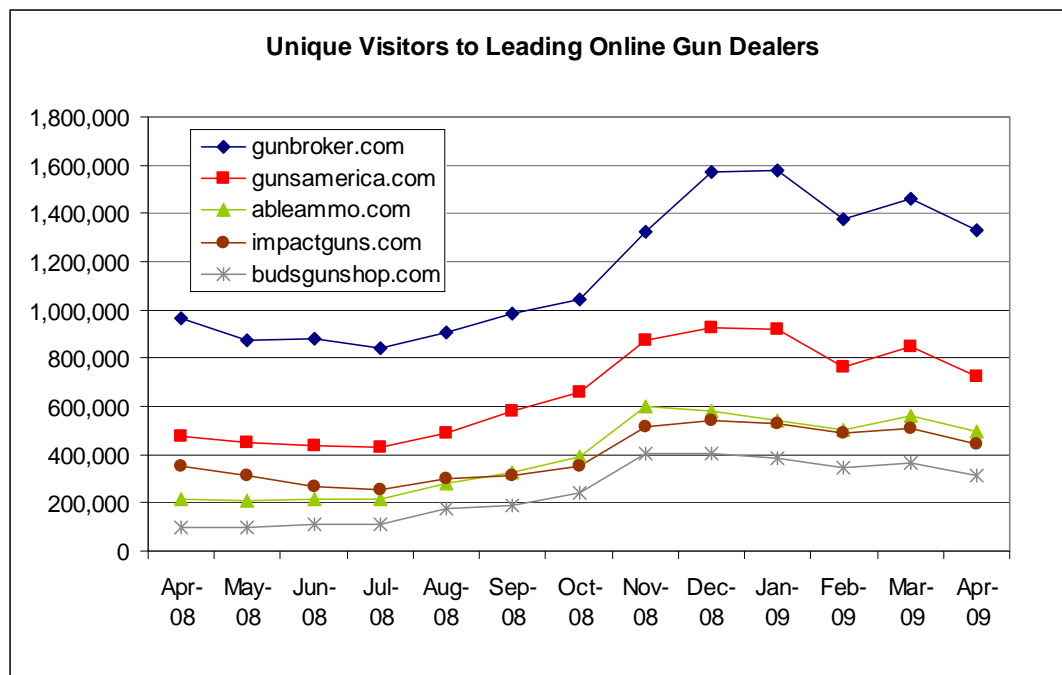
As of the end of April, the short interest in SWHC stood at 2.9 million shares, or roughly 2.6 days to cover. The short interest in the company peaked in October of this year. The short interest in RGR shares now stands at 934K shares, or 1.8 days to cover.

In general, there has been little insider activity in RGR shares. SWHC recently completed a 5.5 million equity offering at \$6.25/share. All of the shares were primary. Proceeds of the offering are expected to be used for general corporate purposes including: acquisitions and potentially paying off SWHC's existing converts.

INVESTMENT THESIS IN DETAIL

Our investment thesis is predicated on the following:

- 1. According to compete.com, the number of unique visitors to the leading online gun dealers has declined almost 20% since December 2008 peaks. Additionally, information gleaned from Google, aka "the database of intentions" suggests the level of interest in purchasing a gun is declining.** We think web traffic is one of the best indicators of current and future consumer activity. Presumably any consumer considering making a purchase of a high priced item will do research on the web beforehand. We think this behavior holds true for gun buyers as well. The good news for gun manufacturers is that the number of unique visitors to the top five online gun dealers was up in excess of 90% YOY in April according to Compete.com. The bad news is that it appears that traffic has already peaked and the number of unique visitors in April 2009 was approximately 20% below that of December 2008. As the chart below demonstrates, traffic trends appear to be on the decline.

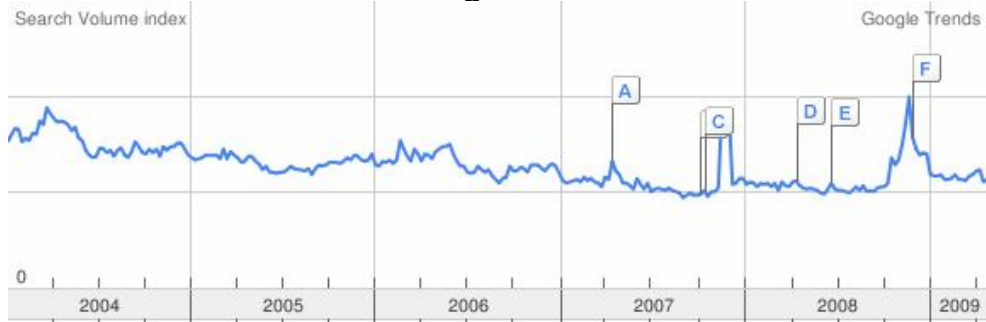


Source: Compete.com, PAA Research

In John Battelle's excellent book [The Search: How Google and Its Rivals Rewrote the Rules of Business and Transformed Our Culture](#), he characterized Google as "the database of intentions". Keyword search terms are in effect indications of intention. Someone typing in "real estate broker" into Google clearly is looking to buy a house, while someone entering "gun dealers" probably is looking to purchase a firearm. We often look at charts provided by

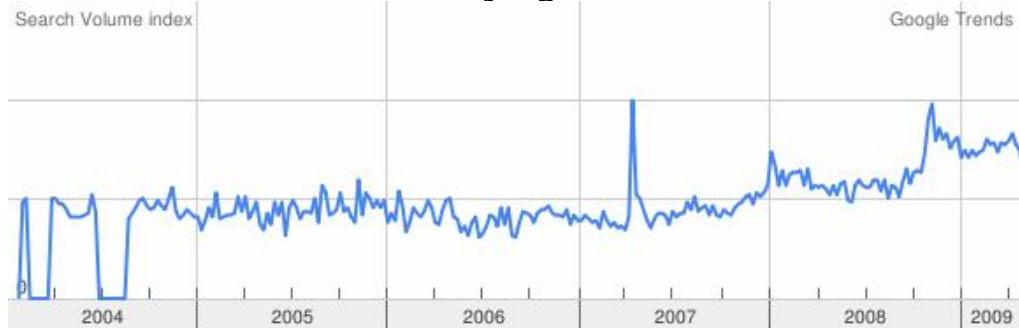
Google Trends as a real time indicator of consumers' interests and intentions. We have looked at the data for three keyword search terms: "guns", "buy a gun", and "gun dealer". In each case, the number of searches under those terms spiked between November-December 2008 and has since fallen off sharply. We think this implies that demand for guns has already started to normalize or will do so in the next few months.

Search volume since 2004 for: "guns"



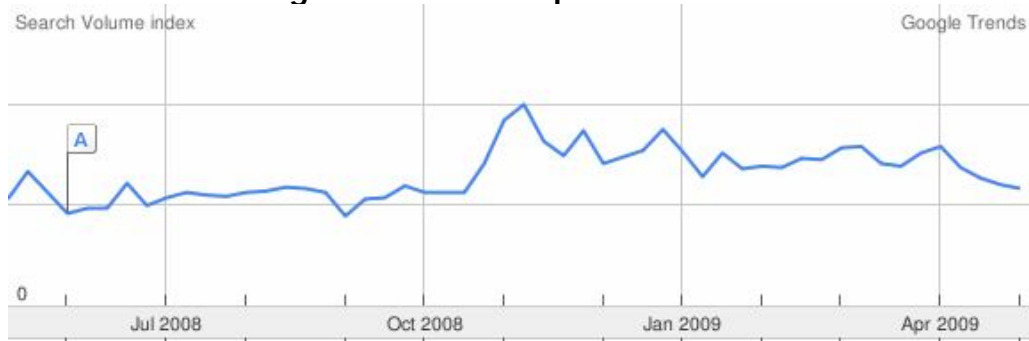
Source: Google Inc.

Search volume since 2004 for "buy a gun"



Source: Google Inc.

Search volume for "gun dealer" in the past 12-months:

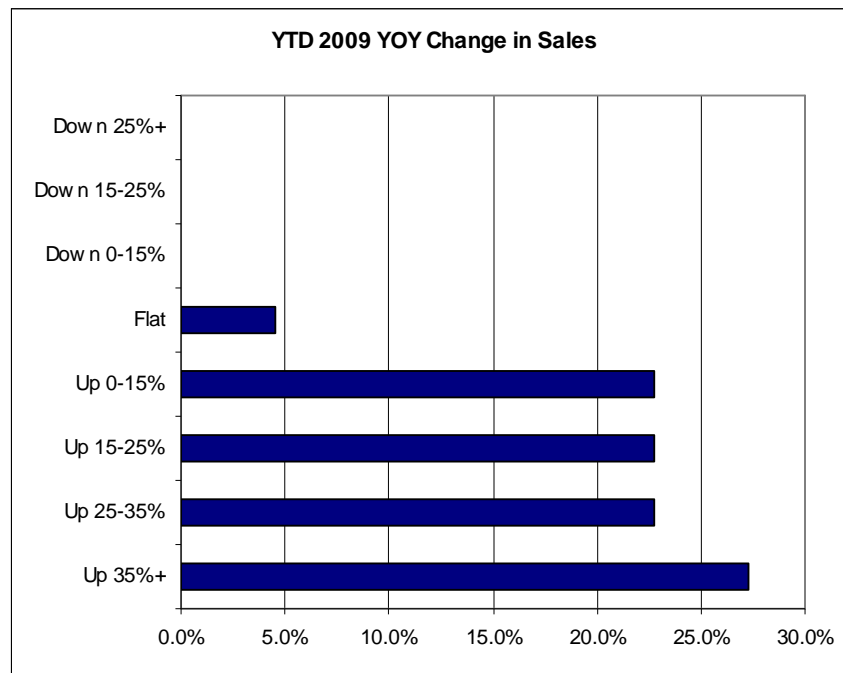


Source: Google Inc.

2. **Our proprietary survey of firearms dealers indicates that sales growth for SWHC and RGR could slow in the back half of the year.** We have conducted a survey of approximately 25 firearms dealers from around the country to gain a better

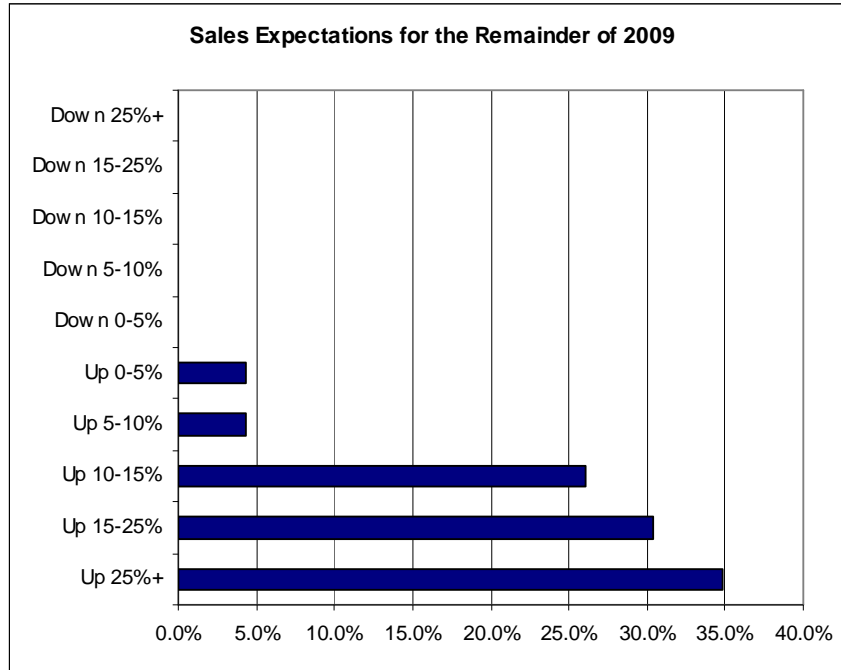
understanding of how they view the recent surge in gun sales. Here are some of the key findings of our survey:

- **100% of respondents indicated that concern about tougher restrictions on gun ownership under the Obama administration was the reason for the surge in gun sales.** This compares to 43% who attributed the increase in gun sales to worries about crime.
- Pistols and ammunition have had the strongest sell through and are currently the most difficult products to source. Sales of hunting related weapons remain depressed. In each of the past two quarters, sales of SWHC's hunting firearms declined more than 40% YOY. We think this could foreshadow how demand might evolve once the boost to sales from the "Obama effect" wanes for handguns.
- Almost every dealer we surveyed has witnessed a sizeable increase in sales thus far in 2009. On average dealers have witnessed a 20-25% increase YOY in sales.



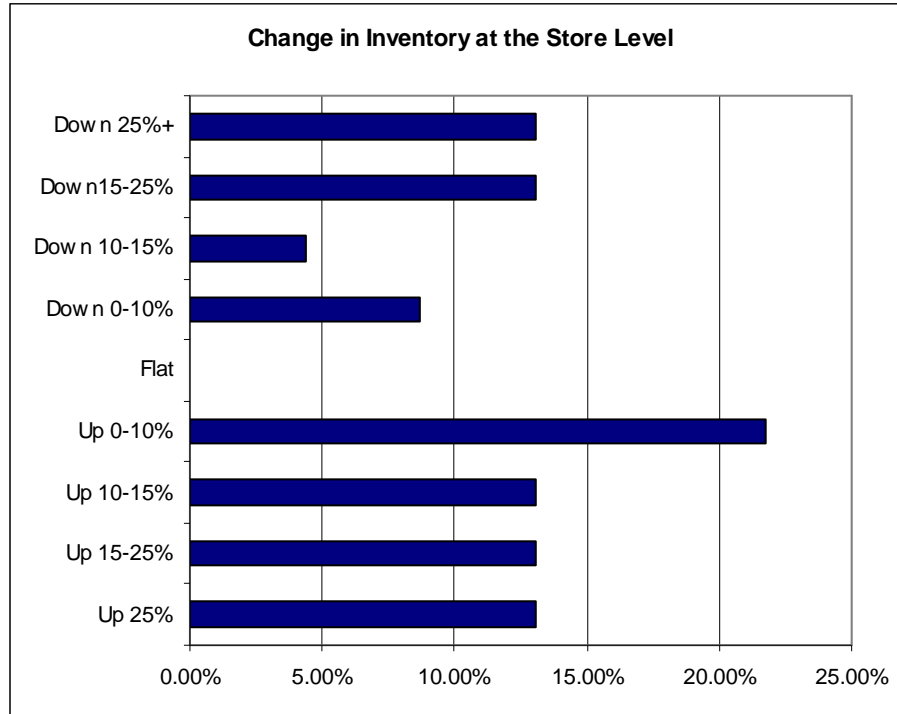
Source: PAA Research

- Pricing has been very strong. The average price on similar products has increased 10-15% YOY thus far in 2009.
- It appears that dealers do not expect the remainder of 2009 to be as strong as the start of the year. A third of respondents now expect sales for the remainder of 2009 to increase less than 15%.



Source: PAA Research

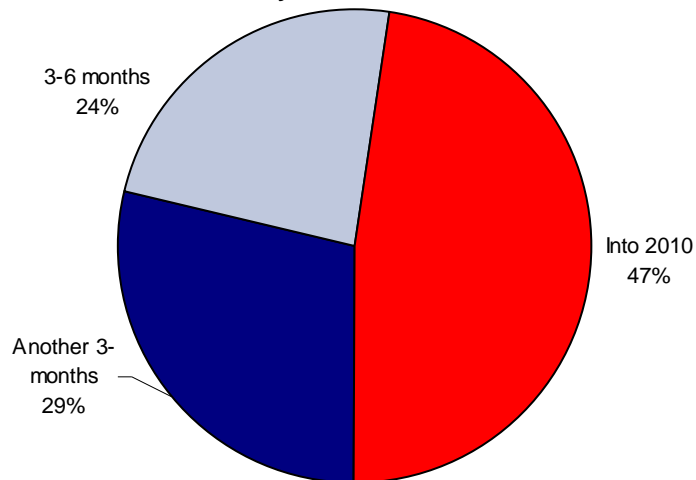
- **A significant portion of stores have already started to build inventory in anticipation of demand.** We read a great deal about the apparent shortages in some product lines, particularly certain pistols and ammunition. We were surprised to learn that more than 60% of the dealers we surveyed currently have higher inventory levels than they did a year ago. If this continues, we think that this could create a glut in the channel when demand slackens if OEMs such as SWHC and RGR don't manage production appropriately.



Source: PAA Research

- Reorders for the spring/summer selling season are expected to increase 5-15% on average.
- Dealers are mixed in their views on how long strong industry-wide firearm sales will last. Approximately 50% see strong sales lasting as long as 3-6 months, while 45-50% see the "Obama effect" lasting into 2010.

Dealer Expectations for Duration of Strong Industry-wide Firearm Sales



Source: PAA Research

3. **The stocks do not reflect the prospects that the Obama administration may eventually address gun control issues.** The Obama administration has been conspicuously quiet about gun rights issues. H.R. 45 (Blair Holt's Firearm and Licensing and Record of Sale Act of 2009) has been the only meaningful bill introduced in Congress related to gun control since the new administration was sworn in. If approved, the law would require gun owners to apply for five-year licenses to own firearms and would give the U.S. Attorney General broad enforcement authority. Thus far the bill is still in committee and has not received any co-sponsorship.

For the moment it appears the Administration has its hands full with the economy and healthcare, and there are no guarantees that anything along the lines of national gun registration will ever be passed. That being said, we thought it might be useful to read how some gun dealers responded to the question: How would a national gun registration system impact your business?

"It would decrease my business upwards of 40%"

"[It would] End it!"

"I would go out of business"

"A lot, sales would go down, stupid law"

"It would cause everything in stock to sell out"

"Negatively as most consumers would feel their right to privacy and 2nd Amendment rights would be infringed upon."

"Poorly"

To be fair, many dealers either didn't respond to the question, indicated they didn't know what the impact would be, or suggested that the impact would be very limited. We foresee two scenarios: 1) the Obama administration does not address gun control at all or not until after the next round of Congressional elections or 2) the Obama administration introduces legislation on the issue sometime in the next 12-months. The latter would likely lead to a surge in gun purchases through 2010 and then a steep drop-off while the former would likely lead to a steady decline in the sale of firearms, similar to what could be transpiring now. It has been our experience that stocks that have significant litigation or regulatory risk trade at a discount to the market, particularly when earnings appear to be disproportionately elevated. Any gun control legislation introduced would likely negatively impact SWHC and RGR shares substantially, in our view.

CATALYSTS

We recommend putting half a short position on at current levels and look to size up should the stocks rally following SWHC's 4Q09 earnings release in early June. In the short term, we expect both stocks to react most to changes in backlog trends.

- 1. SWHC 4Q09 Results (first week of June).** We think consensus expectations remain too low for 4Q09. Despite continued weakness in demand for hunting related firearms, we anticipate 35-40% growth in revenues from pistols, revolvers and tactical rifles should enable SWHC to beat consensus expectations. Guidance, will be another key driver of SWHC and RGR's stocks, we think SWHC management could guide above current street consensus for revenues. Historically, SWHC has not provided detailed EPS guidance.
- 2. Updated NICS data (second week of June).** Although it's not a perfect proxy, the NICS data provided by the FBI has become the best real-time barometer of gun sales. Should the data continue to show sequential declines, we think SWHC and RGR sales could sell off.

PROBABILITY WEIGHTED RETURN

Looking at the return on investment based not only on current valuation, but the probability weighted return given our conviction level

Upside Conviction Level: 70%

A quick look at valuation: Neither SWHC shares, nor RGR shares appear egregiously valued when looked at on LTM or 12-month forward estimates. However, we think it is important to recognize that these are likely peak estimates and these companies are highly cyclical. It is difficult to tell how much demand has been "pulled forward" as a result of concerns about new gun control laws. We anticipate that industry-wide sales could be depressed for 1-2 years following this recent spike. Both SWHC and RGR trade at approximately 15-16x their FY1 EPS estimates, which we think is pricey for peak cycle earnings.

We think SWHC shares could trade to \$3.75 and RGR shares to \$7.50 by the end of the year: We think both stocks will be increasingly valued on "normalized" earnings as investors become increasingly aware that the impact of the "Obama effect" on gun sales has peaked. We think 15x normalized earnings for these companies is an appropriate multiple given their relatively low earnings visibility, substantial legal and regulatory risk, and modest returns on equity. In the case of SWHC, we view normal earnings power as \$0.20-\$0.25, applying a 15x multiple would imply a stock price of \$3.00-\$3.75. For RGR, we think normalized EPS is \$0.45-\$0.50, which would a price of \$6.75-\$7.50.

Total Probability Weighted Return: In order to better allocate capital from a timing and sizing perspective, we think it is important to look at each position on a probability weighted return basis. Overall, we think there's a 70% chance that both SWHC and

RGR shares will trade lower over the next 6-9 months. We expect both companies to beat consensus expectations in their upcoming quarters. We would use any strength in these stocks to sell out or increase the size of a short. The stocks are oversold currently, so we think investors need to size their positions appropriately heading into what could be perceived as a series of positive data points in the next few months. Overall the probability adjusted return is -11.1% for SWHC and -18.2%, which we think is compelling for a 6-9 month trade.

SWHC							Total Probability Weighted Return
Return Matrix	Current Price	Target Price	Conviction Level	Absolute Return	Holding Period	Annualized Return	
Upside	\$4.81	\$3.25	50.0%	-32.4%	0.5x	-64.9%	-11.1%
Base	\$4.81	\$4.25	20.0%	-11.6%	0.5x	-23.3%	
Downside	\$4.81	\$6.00	30.0%	24.7%	0.5x	49.5%	

RGR							Total Probability Weighted Return
Return Matrix	Current Price	Target Price	Conviction Level	Absolute Return	Holding Period	Annualized Return	
Upside	\$10.63	\$7.25	50.0%	-31.8%	0.5x	-63.6%	-18.2%
Base	\$10.63	\$8.50	20.0%	-20.0%	0.5x	-40.1%	
Downside	\$10.63	\$11.25	30.0%	5.8%	0.5x	11.7%	

Source: PAA Research LLC

HEDGING STRATEGIES TO CONSIDER

Choice of Hedge: There are almost no natural hedges to a short position in both RGR and SWHC. If we were to consider a pair trade between the two, we would consider long SWHC/short RGR, at this stage we see more relative downside to RGR shares given their lack of traction in the law enforcement/military channel, which could serve as a buffer to SWHC earnings once consumer purchases of handguns decline.

Relevant upcoming events:

First week of June

SWHC 4Q09 Results

Relevant upcoming events:

1 st /2 nd week of June

NICS data

Relevant upcoming events:

1 st /2 nd week of July

NICS data
