Fixed Income – High-yield bonds

Heckler & Koch (not covered), an example of a distressed issuer

- **Recently downgraded to Caa2 from Caa1**
- **Lack of liquidity is the main problem**
- **The company benefits however from strong brand recognition and diversification**

H&K, one of the bonds trading at a discount

After the strong rally in corporate bonds, close to 100% of the outstanding bonds are trading above par. One of the few examples of a bond at a discount – outside Greece and Portugal – is Heckler & Koch (H&K), a German arms manufacturer. We would like to highlight the risks and chances that are typical for the few bonds remaining deeply depressed in the current low-yield environment.

A company with good diversification

Heckler & Koch is a German firearm and ammunition manufacturer. It designs, manufactures and sells products ranging from small pistols to assault rifles and grenade launchers. H&K is one of the leaders in the section of privately owned defence contractors in the small arms sector. H&K supplies the armed forces of NATO and its allies, European and US Special Forces as well as law enforcement agencies. It also provides parts and services to the military sector.

The actual and only outstanding note (EUR250m), a callable bond maturing in May 2018 with a coupon of 9.5%, is actually priced at EUR 65.52. This gives a yield to call of ca. 19% before taxes. The asset swap spread is 1786bps. The bond was traded around EUR 95 until August 2011 before it fell. The drop was not the consequence of a change in the company but rather in the defence environment driven by budget cuts.

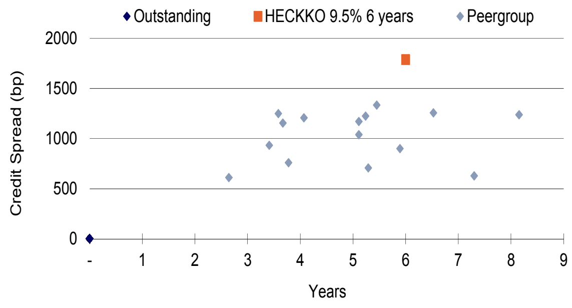
Strong brand recognition and large know-how

The company's new rifle HK 416 is one of its most promising products. It has already been adopted by the Norwegian army (8,200 units) and is in use in 14 other countries, mainly by units of Special Forces. The modern concept of the rifle (2005) gives it a competitive edge over its competitors. The French army as well as the Australian and US Special Forces are actually testing the rifle to replace the outdated FAMAS and Colt M4, respectively.

Coupon dates have a material impact

It is worth mentioning that the bond prices are subject to massive volatility around the coupon-payment dates, Although the bonds officially trade at 'clean prices', i.e. they are traded with accrued interest, the bond prices moved higher ahead of the November coupon-payment date and fell thereafter. As the company has sufficient cash to pay the next coupon, it is likely that this highly speculative bond will appreciate in value in the near term. If we expect the same gap in May 2012 as we saw in November 2011, investor can also play with the price in a short-term view just before the coupon payment.

H&K compared to peers



Source: Bloomberg Finance L.P., Julius Baer

Liquidity is the main concern

The main concern about the future of the company is its scarily low level of liquidity combined with a debt-to-EBITDA ratio of 6.8x (compared to 2.9x one year earlier). Moody's believes that the company should be able to pay the coupon in May. But if no new contract is signed before November 2012, H&K is highly expected to default or at least restructure its debt.

Budget restriction

A major risk for the company is the fact that the defence budgets are being cut in most developed countries. This of course reduces the number of orders for weapon manufacturers. Nevertheless, H&K weapons are mainly used by Special Forces, which are less impacted by budget cuts. In fact, in the light of recent events, these units have highlighted theirs capacity to operate very fast and accurately at a lower cost than the regular army. The crucial question is whether H&K will win a contract in the next six months in order to boost liquidity and equilibrate its balance sheet.

Source of credit ratings: Moody's

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