

Callaway Golf Co.

NYSE:ELY

Analyst: Joseph Gonyeau

Sector: Consumer Goods

BUY

Price Target: \$11.02

Key Statistics as of 2/18/2016

| | |
|----------------|----------------|
| Market Price: | \$9.35 |
| Industry: | Sporting Goods |
| Market Cap: | \$881.88M |
| 52-Week Range: | \$7.97-\$10.30 |
| Beta: | 1.26 |

Thesis Points:

- Bolstered margins, net income, and EPS on a current currency basis show that Callaway is poised for long term value creation
- Golf is becoming more popular for younger generations, enabling Callaway to tap into a growing market
- Callaway is utilizing its large cash balance to make acquisitions which will spark long-term revenue growth

Company Description:

Headquartered in Carlsbad, California, Callaway Golf designs, manufactures and sells premium quality golf balls, golf clubs, golf bags, and a variety of other golf accessories. Callaway's golf products are designed for players of all skill levels, both amateur and professional; their products are technologically advanced and thus they invest a considerable amount into research and development. Callaway's revenues are generally derived from two dominant sources, golf clubs and golf balls, and it sells its products directly to golf retailers, sporting goods retailers, mass merchants, and to third-party distributors in the United States, as well as roughly 100 countries. Callaway has seen its stock price move sporadically between \$7.97 and \$10.30 throughout the year, before recently returning to a price around \$9.40; however, a strong 2015 paired with revised earnings estimates to the upside of FY2016 indicate that Callaway is in a great position to tap deeper into the growing golf market. This paired with their large cash balance and growing market share signal that the stock is very bullish.

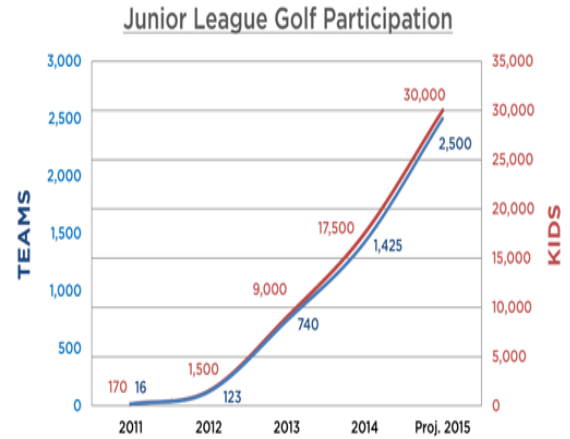


Thesis

Callaway Golf Co. is one of the premier golf brands in the world, commanding a 21% share of the U.S. golf market. It is also the leading American golf brand in both Japan and Europe. On a constant currency basis, Callaway saw net sales, gross margins, pre-tax income, and earnings per share increase in 2015. After its Q1 2016 earnings call, Callaway revised estimates on the upside, with investors anticipating increased revenue and EPS for both Q2 and FY2016. To compound this, the golf industry is on the brink of booming like never before due to the growing number of younger players. With bolstered margins and increasing market share, Callaway stands ready to capitalize on the rapidly expanding golf market, making now the perfect time to buy a very bullish stock.

Industry Outlook

Golf is a \$70 billion per year industry employing nearly 2 million Americans with \$55.6 billion in annual wage income. The future of the industry is very bright as consumer confidence has returned to pre-recession levels and participation in golf has stabilized, evidenced as rounds per playable day increased last year. To compound this, according to the National Golf Foundation, rounds played were up 2% since 2014. Golf has traditionally been labelled as an “old-man’s game,” yet popular players such as Jordan Spieth (age 22) and Rickie Fowler (age 27) are rebranding the game and encouraging younger generations to follow and play golf. Currently, more youth golfers age 6-17 are joining the game, with more than 3 million participants in this age group. Evidenced through junior league golf participation, the number of youths playing golf has increased by over 500,000 participants from 2010 to 2015, outpacing other major sports, as can be seen in the graph below from the National Golf Foundation.



As of last year, there were roughly 30,000 junior league golfers on 2500 teams throughout the country, a figure that PGA CEO Pete Bevacqua anticipates to triple in the next few years. To add to this, Millennials aged 18-34 are also active in the game, accounting for an estimated 6.3 million golfers. As this \$70 billion dollar industry is set to expand, Callaway is in perfect position to see bolstered revenues through its commanding 21% United States market share.

Business Model

Callaway has two reportable operating segments that are organized on the basis of products: the golf clubs segment and the golf balls segment. The golf clubs segment consists of Callaway Golf woods, irons, hybrids and wedges, and Odyssey putters. The golf clubs segment also includes other golf-related accessories, royalties from licensing of the Company’s trademarks and service marks. The golf balls segment consists of Callaway Golf and Strata balls that are designed, manufactured and sold by Callaway. Products are typically sold through retailers, both directly and through their wholly-owned subsidiaries, as well as to their third-party distributors. The Golf Clubs segment is the dominant revenue driver, accounting for 83% of revenues (including “Accessories and other”) in 2015. Callaway brands itself as a high quality golf company that strives to be the best at premium total performance golf equipment and balls. Much of their major marketing is done through their pro sponsorships, including legendary golfer Phil Mickelson, a 42 time PGA tour event winner. Callaway generates slightly more than 50% of its revenues overseas, predominantly in Japan and Europe, where it is the top-selling American golf brand. When reported in US dollars, unfavorable exchange rates from 2013 through 2015 had a significant negative impact on Callaway’s net

sales. Callaway's golf products, including irons, putters, golf balls, and accessories compete at a variety of prices within each category, striving to be the top quality product.

People

Callaway has struggled since the death of their founder Ely Callaway in 2001. Following his death, shares fell by more than \$15 in a three year period. In August of 2005, Callaway hired former Revlon executive George Fellows, but after seven years of struggling, hired Chip Brewer to take control of Callaway. Before Callaway, Brewer spent a decade as the CEO of Adams Golf, achieving tremendous success. During his time at Adam's golf, Brewer undertook a number of acquisitions, with one of the most successful being a \$1.6 million acquisition of Yes! Golf, a company that makes putters. Since he began in 2012, Brewer has implemented an old-school turnaround strategy revolved around building better products, energizing the company's culture and touting performance in advertising. Brewer has also put his previous acquisition experience to good use, as under his management Callaway has made successful acquisitions that are set to help revive the brand.

Acquisitions

Recently, Callaway acquired a 20% stake for \$50 million in TopGolf, a growing golf centered entertainment facility headquartered in Dallas, Texas, with locations throughout the United States and the UK. TopGolf helps players hone their skills, while simultaneously turning practice into a fun game. Their platform includes a game that utilizes microchip technology inside golf balls which are shot into a variety of targets with real clubs to earn points. The balls track the distance, trajectory, and accuracy of each ball. The company considers itself to be much more than just a sports venue, offering a full bar and restaurant at each venue. TopGolf's fun and innovative atmosphere has proven to be a success, drawing more than 8 million patrons in 2015. To add to this, TopGolf also has a very ambitious plan to expand internationally, to areas including Australia, France, South Africa, Dubai, Russia, and Spain. Through its partnership, Callaway will have a massive built-in marketing opportunity, as every location

exclusively offers Callaway balls and clubs. Analyst estimates maintain that Callaway's 20% stake in TopGolf is now valued between roughly \$120 and \$160 million. Callaway also recently announced that it had settled on a joint venture with TSI Groove & Sports Co., a Japanese clothing maker. Their previous partnership only allowed TSI to license the Callaway brand name; the new relationship will help bolster Callaway's international reputation.

Financials

Callaway currently generates more than 50% of its revenue from foreign sales, predominantly in Japan and Europe. When reported in US dollars, unfavorable exchange rates ultimately caused revenues to take a serious hit; however, this is no indication of any form of operational deficiency on Callaway's part. In fact, on a constant currency basis, Callaway saw net sales, pre-tax income, gross margins, and EPS all increase in 2015. More promising than this is their commitment to improving operations and bolstering margins. From 2014 to 2015, gross profits rose over 500 basis points, and are expected to jump another 160 basis points throughout 2016. Analyzing their trend in costs, we can see that Callaway is dedicated to bolstering its profit margins, with cost of revenue down 17% since 2012. As of Wednesday, Callaway had its seventh consecutive earnings beat. After their Q1 2016 earnings call, Callaway revised estimates to the upside, with investors anticipating Q2 revenue between \$238 and \$245 million, and an increase in anticipated EPS of \$0.33 to \$0.37. Based on proforma valuation and the growing golf industry, I anticipate Callaway's revenues to grow around 4.06% from FY2016 to FY2017. I anticipate growth to increase to around 4.85% by 2021, before slowly tapering off to a continuing period growth of 2.13%. Furthermore, based on my proforma valuation and Callaway's history of bolstering margins, I anticipate operating costs/revenue to be 94% in FY 2016. I then anticipate them to decline to the low 90s for the next few years, before tapering off to an industry average around 81%. Based on the proforma, I have an intrinsic value for Callaway at \$9.33, just \$.01 below their current post earnings price of \$9.34. I believe that Callaway

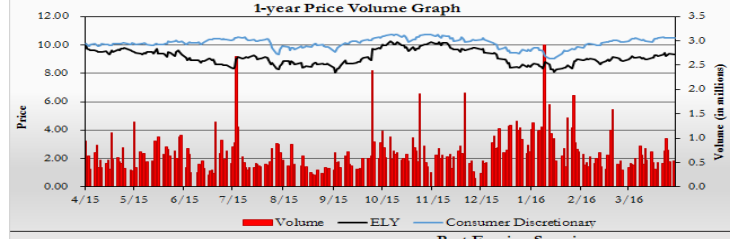
will smash its 52-week high, and have a 1-year target price of \$11.02, for a 1-year return of 18.34%.

Conclusion

Although exchange rates have hurt Callaway of late, they in no way indicated poor operational performance. When analyzing Callaway on a current currency basis, we can see that their net income, earnings per share, and gross margins have actually increased. Along with this, their share in TopGolf, which is valued between \$120 and \$160M, will provide global marketing that Callaway has never seen before, putting them in a great position to tap into a growing market. Golf is a lifelong game, and the whole industry has been benefiting from players getting involved at younger ages. Players like Rickie Fowler and Jordan Spieth are changing the game and making it more appealing to younger players, evident as the number of kids participating in golf has increased by over 500,000 participants since 2010. Strong operational performance, growing brand awareness, and successful acquisitions leave Callaway Golf poised to tap into the expanding \$70 billion golf industry. Thus, now is the perfect time to enter into a 1 year position on a very bullish stock.

Callaway Golf Co. (ELY) **CENTER FOR GLOBAL FINANCIAL STUDIES** **BULLISH**

Analysis by Joseph Gonyeau 4/29/2016 Current Price: \$9.35 Intrinsic Value: \$10.49 Target Price: \$20.44
Divident Yield: 0.5% Target 1 year Return: 119.02% Probability of Price Increase: 100%



Description
Callaway Golf Company, together with its subsidiaries, designs, manufactures, and sells golf clubs, golf balls, golf bags, and other golf-related accessories.

General Information
Sector: Consumer Discretionary
Industry: Leisure Products
Last Guidance: November 3, 2015
Next earnings date: July 28, 2016
Estimated Country Risk Premium: 5.63%
Effective Tax rate: 29%
Effective Operating Tax rate: 33%

Market Data

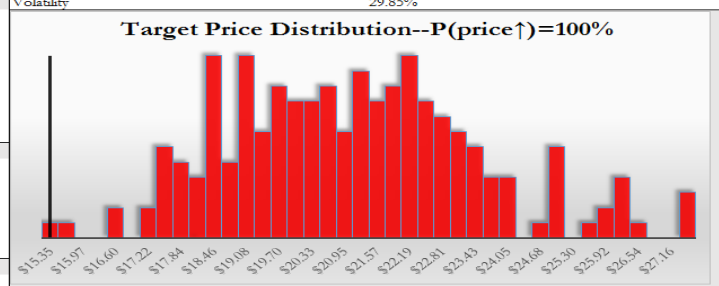
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|---------------------------------------|----------|
| Market Capitalization | \$874.85 |
| Daily volume (mil) | 2.51 |
| Shares outstanding (mil) | 93.77 |
| Diluted shares outstanding (mil) | 87.17 |
| % shares held by institutions | 78% |
| % shares held by investments Managers | 64% |
| % shares held by hedge funds | 16% |
| % shares held by insiders | 0.81% |
| Short interest | 2.72% |
| Days to cover short interest | 3.37 |
| 52 week high | \$10.30 |
| 52-week low | \$7.97 |
| Levered Beta | 0.86 |
| Volatility | 29.85% |

Past Earning Surprises

| Quarter ending | Revenue | EBITDA |
|----------------|---------|----------|
| 3/31/2015 | -11.36% | -20.24% |
| 6/30/2015 | -3.15% | -1.93% |
| 9/30/2015 | -1.47% | 50.30% |
| 12/31/2015 | 2.22% | -202.92% |
| 3/31/2016 | -8.65% | 16.09% |
| Mean | -4.48% | -31.74% |
| Standard error | 2.5% | 44.4% |

Peers

| |
|-----------------------|
| Nautilus Inc. |
| Malibu Boats, Inc. |
| Brunswick Corporation |
| Aretic Cat Inc. |
| Marine Products Corp. |
| Escalade Inc. |
| Black Diamond, Inc. |

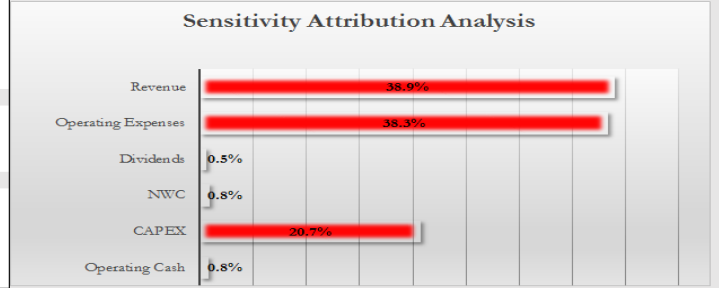


Management

| | |
|------------------|------------------------------|
| Brewer, Oliver | Chief Executive Officer, Pre |
| Julian, Robert | Chief Financial Officer and |
| Leposky, Mark | Senior Vice President of Glo |
| Howie, Neil | Managing Director of Europe, |
| Hocknell, Alan | Senior Vice President of Res |
| Thomas, Jennifer | Chief Accounting Officer and |

Total compensations growth

| |
|--------------------------|
| -0.61% per annum over 3y |
| N/A |
| 14.03% per annum over 2y |
| 13.43% per annum over 3y |
| -100% per annum over 1y |
| N/A |



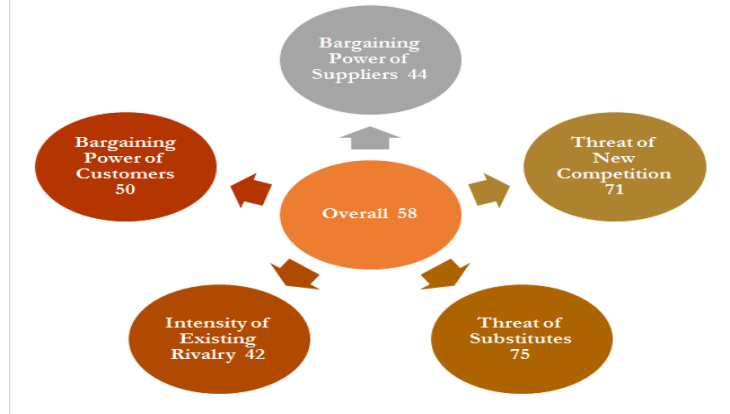
Profitability

| | ELY (LTM) | ELY (5 years historical average) | Industry (LTM) |
|-----------------------------|-----------|----------------------------------|----------------|
| ROIC | 3.5% | 3.25% | 11.92% |
| NOPAT Margin | 4% | 7.02% | 9.9% |
| Revenue/Invested Capital | 0.84 | 0.46 | 1.20 |
| ROE | 3.1% | 2.21% | 13.35% |
| Adjusted net margin | 3% | 6.11% | 9.0% |
| Revenue/Adjusted Book Value | 0.95 | 0.36 | 1.49 |

Total return to shareholders

| |
|--------------------------|
| 11.44% per annum over 3y |
| 0% per annum over 0y |
| 6.21% per annum over 2y |
| 11.44% per annum over 3y |
| 22.86% per annum over 1y |
| N/A |

Porter's 5 forces (scores are out of 100)



Revenue growth

| Period | Revenue growth |
|-------------------|----------------|
| Base Year | 5.9% |
| 3/31/2017 | 4.1% |
| 3/31/2018 | 4.7% |
| 3/31/2019 | 4.9% |
| 3/31/2020 | 5.0% |
| 3/31/2021 | 4.9% |
| 3/31/2022 | 4.5% |
| 3/31/2023 | 3.8% |
| 3/31/2024 | 3.3% |
| 3/31/2025 | 2.4% |
| 3/31/2026 | 2.3% |
| Continuing Period | 2.1% |

Valuation

| | NOPAT margin | ROIC/WACC |
|-------------------|--------------|-----------|
| Base Year | 4.1% | 0.41 |
| 3/31/2017 | 5.9% | 0.55 |
| 3/31/2018 | 8.5% | 0.76 |
| 3/31/2019 | 8.6% | 0.75 |
| 3/31/2020 | 9.4% | 0.79 |
| 3/31/2021 | 10.1% | 0.83 |
| 3/31/2022 | 10.7% | 0.85 |
| 3/31/2023 | 11.2% | 0.86 |
| 3/31/2024 | 12.0% | 0.88 |
| 3/31/2025 | 12.6% | 0.89 |
| 3/31/2026 | 13.4% | 0.92 |
| Continuing Period | 14.2% | 0.95 |

Invested Capital

| Period | Invested Capital |
|-------------------|------------------|
| Base Year | \$999.04 |
| 3/31/2017 | \$1,090.72 |
| 3/31/2018 | \$1,045.71 |
| 3/31/2019 | \$1,013.69 |
| 3/31/2020 | \$1,028.35 |
| 3/31/2021 | \$1,147.65 |
| 3/31/2022 | \$1,207.79 |
| 3/31/2023 | \$1,266.32 |
| 3/31/2024 | \$1,332.16 |
| 3/31/2025 | \$1,401.95 |
| 3/31/2026 | \$1,474.18 |
| Continuing Period | |

Net Claims

| | Net Claims | Price per share |
|-------------------|-------------|-----------------|
| Base Year | \$136.84 | \$9.20 |
| 3/31/2017 | \$77.53 | \$10.87 |
| 3/31/2018 | -\$24.62 | \$12.82 |
| 3/31/2019 | -\$124.56 | \$14.87 |
| 3/31/2020 | -\$233.55 | \$17.05 |
| 3/31/2021 | -\$354.81 | \$19.37 |
| 3/31/2022 | -\$484.25 | \$21.76 |
| 3/31/2023 | -\$625.70 | \$24.24 |
| 3/31/2024 | -\$781.41 | \$26.80 |
| 3/31/2025 | -\$952.85 | \$29.42 |
| 3/31/2026 | -\$1,136.54 | \$32.10 |
| Continuing Period | | |