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BJORKLUND FUND

February, 14, 2017

Callaway Golf Company: ELY

John Graziano

Sector: Consumer Discretionary
Industry: Sporting Goods
Current Price: $15.22
Target Price: $18.43

Company Description: Callaway Golf Company operates out of Carlsbad, CA. Where the company designs, develops, and markets golf clubs, balls, and golf accessories. The company manufactures titanium drivers, fairway woods, irons, wedges and putters. Callaway is a leader in advanced golf technology both domestically and internationally. Along with the manufacturing of clubs and balls, Callaway has recently acquired companies on the apparel side of the golf business.

BUY

Current Price:	$15.22
Target Price:	$18.43
Market Cap:	1.465B
Average Volume:	1.03M
D/E Ratio:	0.13
ROIC:	11.6%
WACC:	9.63%
Short Interest:	6.58%/6.5 Days

Thesis:

Callaway Golf Company is poised to build off a strong FY 2017 where the company saw growth in every segment within every sector. The new Rogue technology will further differentiate Callaway versus the competition within the golf club space. The new ChromeSoft golf ball will take an even larger bite out of Titleist's market-leading position. Lastly, the continued incorporation of the OGIO and TravisMathew acquisitions will spur growth in the golf industry's leading category. This will lead to an increase in share price for Callaway over the following year.

Catalysts:

- **Short Term(within the year):** Strong Q1 as expressed in Q4 2017 Earnings Call, Continued margin growth in ball segment
- **Mid Term(1-2 years):** Runway for growth in both TravisMathew and OGIO acquisitions, turnaround in golf industry as a whole
- **Long Term(3+):** Continued M&A success, Possible gain from TopGolf IPO

Industry Performance and Outlook:

The golf industry has been under a great deal of pressure from both external and internal factors. This resulted in the bankruptcy of the major retailer in the space (GolfSmith) in late 2016 and the exit of major players such as Nike. However, as the 2018 season is coming into focus it appears that trend is bottoming out. According to Golf Datatech the equipment portion of the industry was down about 2% in 2017, with apparel being up 6% over the same period. This led to an increase in sales of 1% combined which makes Callaway's revenue increase of 20% year over year very impressive. The most recent Golf Datatech outlook for 2018 stated that

> "Consumer research in late 2017 suggested the US Golfer is finally adjusting to higher prices for new equipment, the reduced new product cadence by the major manufacturers (which means fewer close outs/price point offerings), as well as higher launch pricing, all of which have driven ASP's to record levels in most categories of golf products across both hard and soft goods."

These higher ASP's will lead to increasing top line growth and operating margins for industry players that are well positioned such as Callaway. Along with these positive factors, a stronger overall macroeconomic environment coupled with the recently issued tax cut will lead to higher consumer confidence and an increase in disposable income. All of these factors should lead to an expanding industry in 2018.

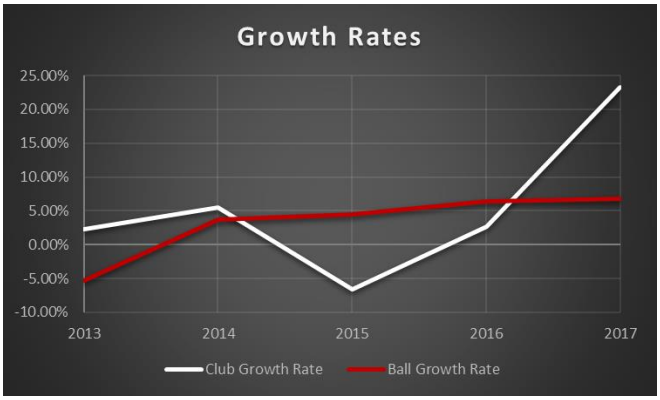
Business Segments:

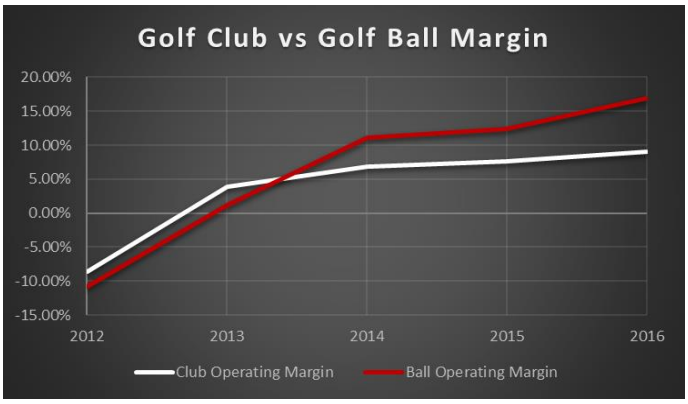
In early 2017, Callaway restructured from two business segments (clubs and balls) to three business segments (clubs, balls, and gear, accessories, other). Callaway holds market-leading positions throughout its golf club segment, is second in market share to Acushnet in golf balls, and just beginning in the gear space through the recent acquisitions of OGIO and TravisMathew. Callaway reported an increase in YoY net sales of 20% due increases in sales across all geographies and operating segments.

Golf Clubs: The club segment is where Callaway has been excelling in recent years holding the number one dollar market share across the board in golf clubs. This has led to a 25.1% market share in clubs which is up roughly 2.5% year over year. A major driver of market share and sales increases in 2017 was the breakout success of the EPIC line of woods containing Callaway's jailbreak technology. According to a Golf WRX study of eight randomly selected individuals, EPIC drivers produced a 5.175 MPH gain in ball speed, 9.837 more yards in carry distance, and 11.675 more yards in total distance versus what the individuals where currently using. This success helped the company advance rapidly in woods and an updated version of Jailbreak Technology will be in the Rogue line of drivers and woods debuting in early 2018.

Golf Balls: This segment is where Callaway is becoming a major disruptor with its new technology in their topline ChromeSoft and ChromeSoft X golf balls. Callaway currently holds a 14.3% market share which has solidified its second place spot in the golf world. Second place is important because as of right now Titleist

(Acushnet: GOLF) continues to be the dominant force in the golf ball industry. In the beginning of 2018 Callaway is releasing an updated ChromeSoft that contains a graphene layer which should increase performance dramatically. Callaway is so confident in this new technology that they have raised prices by 13% to $44.99 a dozen which is still below Titleist's Pro V1 and Pro V1X which come in at $56 a dozen. In this segment Callaway should see significant YoY growth in terms of both net sales and gross margin improvement.



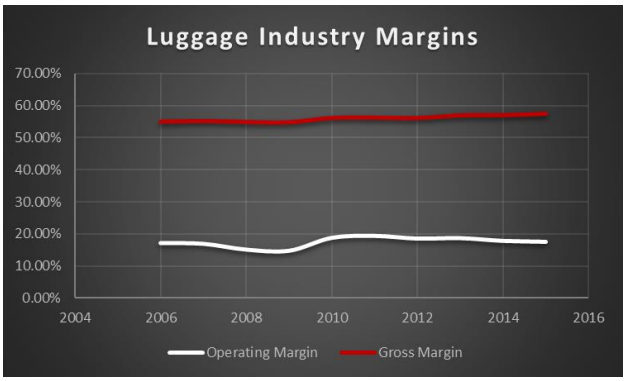


Gear, Accessories, and Other: The newest of the segments for Callaway was created in order to accommodate the company's expansion into tangential businesses. This was kicked off with the initiation of an apparel joint venture in Japan which has been successful so far. The two recent acquisitions of OGIO and TravisMathew fall into this segment as well. This is the segment with the larges runway to growth and the highest margin capabilities as evidenced by Titleist's margins in their comparable segment.

Recent Acquisitions/Investments:

Callaway has completed two major acquisitions in the last twelve months in OGIO and TravisMathew. These companies are both tangential to the golf industry with OGIO producing hard goods such as bags and backpacks and TravisMathew producing golf and other lifestyle apparel. According to the Q4 earnings call both businesses are either on or ahead of schedule post acquisition. Combined they contributed around 65-70M in net sales increases over last year. This is coupled with better operating margins in comparison with the rest of Callaway's core golf businesses.

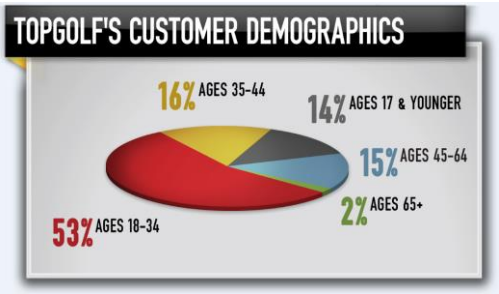
OGIO: The OGIO acquisition was completed in January, 2017 at an adjusted all cash purchase price of $65.95M which translates to an EV/EBITDA multiple of 6.5x. OGIO gives Callaway another means of revenue within the golf bag portion of the industry. Where Callaway maintains a classic look and feel, OGIO can market to a younger demographic with fresher design. OGIO also makes various other bags including travel, athletic and schoolbags, this gives Callaway exposure to a less seasonal industry as well. The luggage industry is also a much higher margin industry both in terms of operating margin and gross margin OGIO contributed around $50M in revenue to Callaway for the full year of 2017.



TravisMathew: The TravisMathew acquisition was completed at the end of August 2017 for $124.6M in an all cash transaction. This resulted in Callaway paying a 10.1 EV/EBITDA multiple which expensive. The price is

justified by the fact that there are significant brand synergies between the two companies. Travis Matthew had full year revenue of $60M of which around $20M is attributable to Callaway. In the Q4 conference call, TravisMathew guidance included double-digit growth accompanied with improving gross and operating margins. Titleist's operating margin for their gear and apparel segment of business has hovered right around 32.5% which is a drastic increase in margin compared to Callaway. In the future these acquisitions will enhance margins, EBITDA, and free cash flow. The development of these acquisitions, without debt, will lead to increase in value and therefor an increase in stock price.

TopGolf Investment: TopGolf blends technology and entertainment to create a driving range that is mixed with an upscale bar/nightclub to create a one of a kind consumer experience. Over 2017, TopGolf attracted 13M unique guests to 40 locations world-wide. Callaway recently invested $20M more into the company bringing the total cost of Callaway's investment to $70.5M which has a street value of over $290M. This equates to around $3.00 of Callaway's share price.



Tour Staff:

Any major golf brand needs PGA Tour exposure, what better promotes a brand than having the best players in the world use your product? Callaway has some of the most recognizable stars in golf with Phil Mickelson, Jim Furyk, and Tom Watson. Callaway also has some of the brightest young players in the game in Daniel Berger, Patrick Reed, and Maverick McNeely. Callaway recently signed the defending Master's champion Sergio Garcia. Sergio also managed to win in his first tournament with a full bag of Callaway equipment. The tour players have also been very positive on the new ChromeSoft containing the graphene layer which is a good sign for the mass marketing of the ball.

Debt:

Callaway carries little to no long term debt on a regular basis. The little debt they do have is in a $330M revolving credit facility which is secured by certain assets, including cash (to the extent pledged by the Company), inventory and accounts receivable of the Company's subsidiaries in the United States, Canada and the United Kingdom. The average applicable interest rate to this portion of debt is as of the end of 2017, 3.18%. There is also a revolving credit line used specifically for business done in Japan which amounts to 3-4B yen that has been extended from a one-year term to a three-year term as of February 2018.

2018 Outlook:

Callaway is looking to build off of a strong FY2017 that saw great success in the Drivers and Woods line and an increase in golf ball market share which is key. There will be three main drivers for advancement in 2018 as far as Callaway is concerned. First, market conditions should continue to build off of the strong close to 2017 and begin to show growth for 2018. Next, on the Q4 conference call Callaway senior executives were very optimistic on the launch cadence for 2018 which includes the Rogue family and new ChromeSoft ball in the first half of the year. Lastly, the continued integration, growth, and margin improvements from both the OGIO and TravisMathew acquisitions going forward. These three factors will lead to growth company company wide and in turn an increase in stock price.

Conclusion:

Taking into account the increasing market share, more beneficial product mix, and the on or ahead of schedule acquisitions, Callaway should be poised for another year of growth. Starting in 2018 the company will see improving EBITDA margin which by 2025 should increase to around 14%. Along with a company-wide revenue growth of 5% this will lead to share price appreciation in both the near and long term windows. My one-year price target for Callaway is $18.43. for a return of 15.81%.

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Callaway Golf Company (ELY)

CENTER FOR GLOBAL FINANCIAL STUDIES

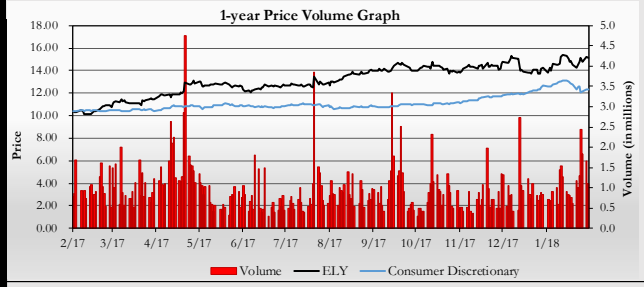
NEUTRAL

Analysis by John Graziano | Current Price: $15.99 | Intrinsic Value $18.52

2/16/2018 | Divident Yield: 0.3% | Target Price $18.37

Target 1 year Return: 15.12%

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 in the United States and internationally.

General Information

Sector	Consumer Discretionary
Industry	Leisure Products
Last Guidance	February 12, 2018
Next earnings date	April 23, 2018

Market Assumptions

Estimated Equity Risk Premium	6.18%
Effective Tax rate	26%

Market Data

Market Capitalization	$1,464.37
Daily volume (mil)	0.81
Shares outstanding (mil)	94.54
Diluted shares outstanding (mil)	96.58
% shares held by institutions	109%
% shares held by investments Managers	73%
% shares held by hedge funds	8%
% shares held by insiders	1.50%
Short interest	6.48%
Days to cover short interest	6.57
52 week high	$15.95
52-week low	$9.99
Volatility	25.60%

Past Earning Surprises

Quarter ending	Revenue	EBITDA
12/31/2016	-3.65%	14.11%
3/31/2017	9.28%	23.52%
6/30/2017	3.45%	9.90%
9/30/2017	15.70%	1212.02%
12/31/2017	4.73%	-19.03%
Mean	**5.90%**	**248.10%**
Standard error	1.0%	12.8%

Market and Credit Scores

Recommendation (STARS) Value--0
Recommendation (STARS) Description--0
Quality Ranking Value--B-
Quality Ranking Description--Lower
Short Score--2
Market Signal Probability of Default % (Non-Ratings)--0.617%
CreditModel Score (Non-Ratings)--bbb-

Industry and Segment Information

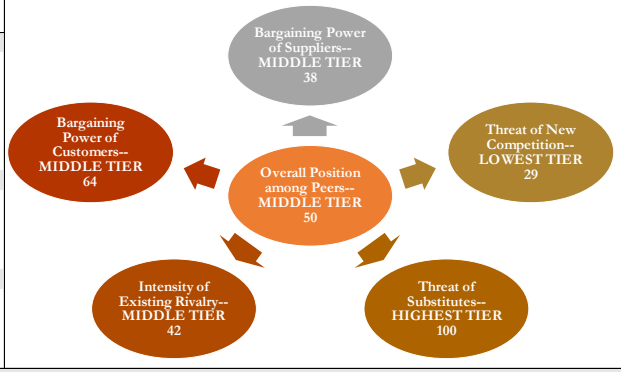
LTN Revenues by Geographic Segments	LTM Revenues by Business Segments
United States--54%	Golf Clubs (Excluding Gear/Accessories/Other)--61%
Europe--13%	Golf Balls--15%
Japan--19%	Gear/Accessories/Other--23%
Rest of Asia--7%	--
Other Countries--6%	--

Peers

Acushnet Holdings Corp.	Johnson Outdoors Inc.
Nautilus, Inc.	Technogym S.p.A.
Malibu Boats, Inc.	Brunswick Corporation
Dunlop Sports Co. Ltd.	Globeride, Inc.
MCBC Holdings, Inc.	Escalade, Incorporated

Management	Position	Total Compensations Growth	Stock Price Growth During Tenure
Brewer, Oliver	CEO, President & Director	2.38% per annum over 4y	7.69% per annum over 4y
Lynch, Brian	CFO, Senior VP, General Counsel & Secretary	13.63% per annum over 2y	19.78% per annum over 2y
Leposky, Mark	Senior Vice President of Global Operations	6.39% per annum over 3y	3.22% per annum over 3y
Howie, Neil	Managing Director of Europe, Middle East & Afri	8.95% per annum over 4y	7.69% per annum over 4y
Thomas, Jennifer	Chief Accounting Officer and Vice President		
Burke, Patrick	Vice President of Finance & Investor Relations		

Porter's 5 forces (Scores are percentiles)



Profitability	ELY (LTM)	ELY Historical	Peers' Median (LTM)
Return on Capital (GAAP)	11.1%	-2.34%	21.30%
Operating Margin	9%	-3.60%	10.55%
Revenue/Capital (GAAP)	1.27	0.65	2.02
ROE (GAAP)	5.0%	30.2%	44.5%
Net margin	3.3%	17.5%	5.3%
Revenue/Book Value (GAAP)	1.50	1.72	8.36
Invested Funds	**ELY (LTM)**	**ELY Historical**	**Peers' Median (LTM)**
Cash/Capital	9.6%	8.7%	16.3%
NWC/Capital	16.2%	26.9%	17.8%
Operating Assets/Capital	74.2%	59.9%	51.1%
Goodwill/Capital	0.0%	4.4%	14.8%
Capital Structure	**ELY (LTM)**	**ELY Historical**	**Peers' Median (LTM)**
Total Debt/Market Capitalization	0.15	0.20	0.42
Cost of Debt	7.8%	10.1%	3.6%
CGFS Rating (F-score, Z-score, and default Probability)	BBB		
WACC	10.2%	15.5%	8.8%

Valuation

Forecast Assumptions	Explicit Period (6 years)	Continuing Period
Revenue Growth CAGR	4%	2%
Average Operating Margin	12%	14%
Average Net Margin	7%	10%
Growth in Capital CAGR	6%	2%
Growth in Claims CAGR	-3%	2%
Average Return on Capital	7%	7%
Average Return on Equity	7%	7%
Average Cost of Capital	9%	9%
Average Cost of EquityKe	10%	10%