

October 15, 2018

Callaway Golf: (ELY)

Eric Munn



Sector: Consumer Discretionary

Industry: Sporting Goods

Current Price:

Target Price:

Business Description: Callaway Golf Company designs, manufactures and sells high quality golf clubs, golf balls, golf bags and other golf-related and lifestyle apparel, gear and accessories. The company is a leader in advanced products with sleek design for both functionality and style.

HOLD

Current Price: \$23.27

Target Price: \$26.61

Avg. Volume: .972M

Market Cap: \$2.2B

D/E: 1.11x

Trailing 12 Month adj. EBIDA Margin Growth: 55%

Short Interest Ratio: 5.2 Days

ROIC/WACC: 2.1x



Green Line: Main Competitor

White: Positive Q2 Earnings Report

Red: Negative analyst report

Green: Additional 20 million Topgolf investment

Thesis:

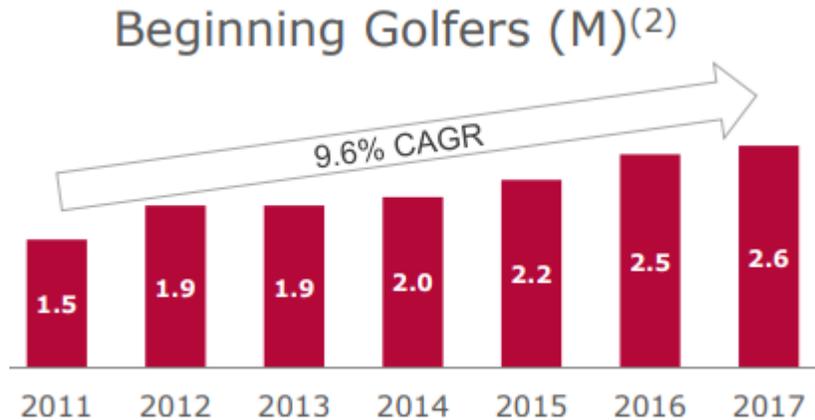
Callaway Golf Company is taking the necessary steps to develop and foster growth across all of its business segments after an extremely strong 1H of 2018. Increases in the market share for balls and a focus on efficient production shows a focus on their most profitable segment. Callaway has strategically deployed capital into complimentary companies that have diversified its earnings. The growth of this company is dependent on the strength of product releases in the 1H of 2019

Catalysts: Forward looking projections that call for positive/negative outlook that will strengthen your thesis. Example:

- Short Term(within the year): Continued increase in ball market share
- Mid Term(1-2 years): Successful product releases for 1H 2019
- Long Term(3+): Increase in golf interest beyond the stabilization of 23-24 million

Industry:

The golf industry is constantly under scrutiny because of its lack of consistent growth. However, participation has increased in important areas. According to National Golf Research, an additional 8.3 million people who played exclusively off course. 21 million total people participated in off course golfing. Golf Datatech research shows a 4% increase in people trying the sport. NGF President, Joe Beditz, provided an overview of the industry conditions: “Golf participation is evolving. On-course, green-grass participation is holding its own and off-course is continuing to grow. There’s no denying that we’re down from our pre-recession highs, but it appears to us that traditional participation is stabilizing and there may be a new support level between 23 million and 24 million.” Overall participation is around 32 million. The recent resurgence of Tiger Woods has sparked interest in the game of golf. Tiger just won his first PGA championship in 5 years. There was 5.2-x increase in ratings YoY for the tournament he won. Callaway is poised to benefit from the macro tailwinds caused by increased viewership and ratings.



Business Segment Analysis:

Golf Clubs: Golf clubs continue to be Callaway’s major edge in the market. 2Q club revenue of \$232.8M grew 18.6 YoY, led by major upside in the Rouge offerings. Callaway had already had major success with the EPIC series, but the new offerings caused a net sales increase of 5.2% for woods, 35% for irons and 12.4% for putters. The success of the product launch is a precursor for more growth upon the next product launch.

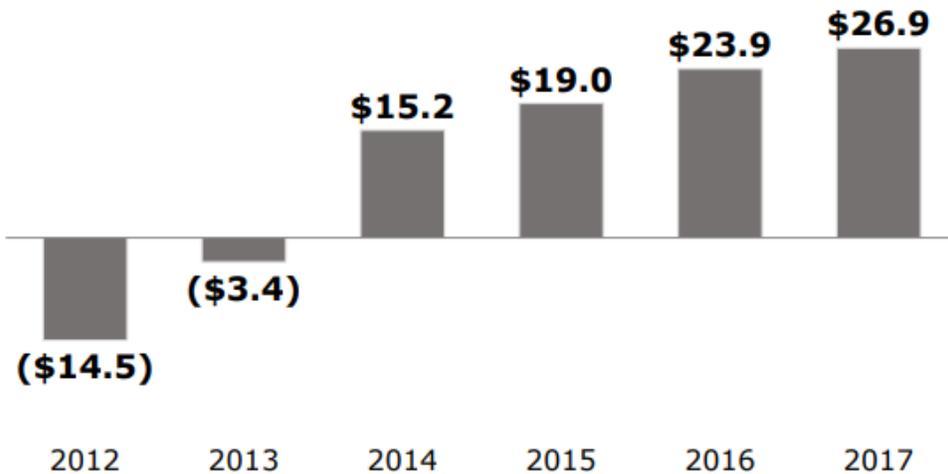
Golf Balls: Balls contributes 15 percent to the revenue. Callaway continues to lag behind its main competitor, Acushnet:GOLF, in ball market share. The market share has increased from around 14% to 16% YoY. The golf ball segment was the most profitable. With a YoY increase of 12.5% on the price for the ChromeSoft X, consumers are becoming more open to quality that is worth the price. The high-level technology is creating more opportunity for market share.



According to an analyst question on the Q2 earnings call, there is room for improvement in margin. A 33 million dollar update on the Chicopee Ball Manufacturing plant will likely improve efficiency and lower costs. The overall profitability should increase as the margins increase. As the smallest piece of revenue, but the most profitable. The expectation is that there will be a continued focus on improvement in this segment.

Segment Profitability(1)

\$ in millions



Gear and Accessories: In August 2017, the Company acquired TravisMathew for \$124.6 million in an all-cash transaction, subject to customary working capital adjustments, and in January 2017 acquired OGIO for \$66.0 million. Callaway made strategic acquisitions of OGIO and Travis Mathew to diversify their earnings. The introduction of this business segment has worked well thus far. There was a 64% increase in the gear, accessories and other category driven by the TravisMathew business. The acquisitions increased the SG&A, but the 1H percentage of revenue is 26%, which is 4% lower than the 1H of 2017.

Off Course Investment:

Callaway is taking advantage of the influx of youth and off course golfers. By keeping up with trends in the industry, the company is refusing to lag behind.

Callaway is the sole brand partner with TopGolf. Topgolf is a combination of a driving range and a bar/nightclub. They initially invested in 2006. They currently have 14% ownership with their investment at 70.5 million. Management believes that the company’s valuation is north of 2.1 billion. They have also been able to realize profit. In 2016, the Company completed the sale of a small portion of its preferred shares of Topgolf for total proceeds of \$23.4 million, and recognized a pre-tax gain of \$17.7 million. While an IPO is unlikely, Callaway has invested in multiple rounds over the past decade and are likely to continue to increase their stake.

Topgolf is a combination of a driving range and a bar/nightclub. It creates a casual atmosphere and creates interest in the game of golf. It had 41 locations as of September 2018 and is looking to grow about 22% in the coming year. 51% of the participants are non-golfers. According to the NGF report, over half of the people who visited off-course golf facilities also golfed on a course at some point during the year. Only 8.3 million people golfed off-course only. Offcourse golf is growing and is helping to grow the entire industry. Callaway is ahead of the rest of the industry with this investment.



PGA Tour Athletes:

The best way to foster brand recognition and sales is through the PGA tour. Tiger Woods last appearance is evidence of the impact of player recognition on golf interest. Callaway has some of the best golfers in the world. They recently introduced Sam Burns (College Player of the Year) and Maverick McNealy (Former #1 in the World Amateur). They are adding young players that will likely become a force in the sport. Management has committed to a strategic pipeline in high schools and colleges to find new athletes. The website features “What’s in the bag”, which highlights the clubs used while winning a championship. Their most recognizable athlete, Phil Mickelson, will be facing off with Tiger Woods on a nine million dollar bet. The event will increase the interest in Callaway Golf because of Woods’s influence and recent Tour Championship. Mickelson will be displaying Callaway’s clubs to the world.



Phil Mickelson



Sergio Garcia



Henrik Stenson



Ollie Schniederjans



Daniel Berger



Michelle Wie



Morgan Pressel



Danny Willett



Tom Watson



Jim Furyk



Kevin Kisner



Branden Grace



Marc Leishman



Xander Schauffele



Aaron Wise

Product Cadence:

Callaway has a length and strong track-record of technologically advanced products. The introduction of the Rouge Line of clubs and Chrome Soft balls helped to drive the 1H YoY growth of 28%. In the 2nd quarter earning calls, analysts had a focus on product cadence. Concerning the 2H. Chip Brewer, the CEO, admitted that the forecasts for 2H “are significantly impacted by product cadence.” The 1H was front loaded with the new products. The market has already adjusted for a 2H with no new launches. Before investing more money into this stock, the future product pipeline needs unveiling. However, because of the release and success of the EPIC line in 2017, the Rouge series and Chrome Soft balls series in 2018, there is a strong upside for betting on a strong 1H of 2019. However, holding the current shares is the right choice for now.

Stock Repurchase:

Callaway announced a stock repurchase plan on May 9, 2018. The company will repurchase up to 50 million in open market or private transactions. While there are no specific deadlines, these buy backs represent management’s confidence in the company’s health. The 2018 Q1 20 million dollar buybacks was a strong indicator that management believed the price was going to increase. It was the largest since 2008.

Fundamentals Graph:

The company is extremely seasonal because of the timing of the golf season. Operating margins are always down in the third and fourth quarter. Investors account for them and rather look forward to 1H. The lack of major price change during the 2H is on the graph below. Callaway has managed to increase their ROIC/WACC. The ROIC/WACC ratio is the biggest driver of the price.

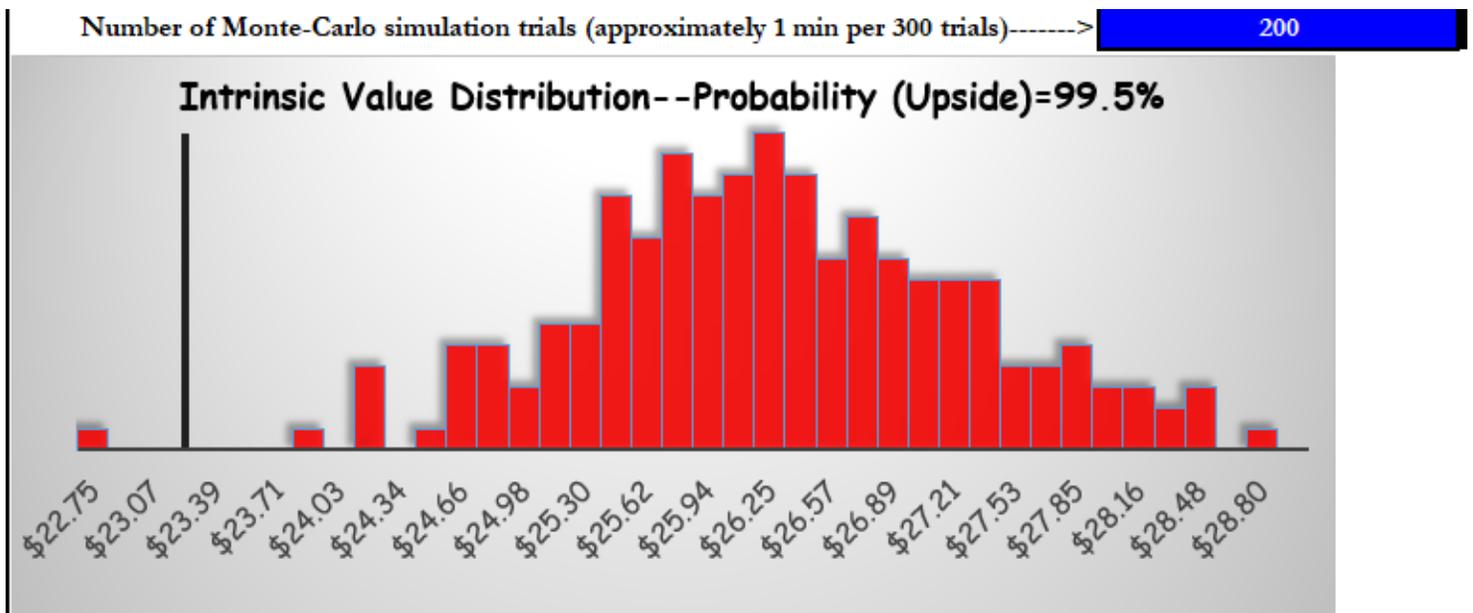


In Millions of USD except Per Share	2016 Q1	2016 Q2	2016 Q3	2016 Q4	2017 Q1	2017 Q2	2017 Q3	2017 Q4	2018 Q1	2018 Q2	Current
3 Months Ending	03/31/2016	06/30/2016	09/30/2016	12/31/2016	03/31/2017	06/30/2017	09/30/2017	12/31/2017	03/31/2018	06/30/2018	10/15/2018
Return on Invested Capital	4.86	5.85	5.40	36.44	28.11	31.83	31.60	8.25	12.24	16.09	16.09
Weighted Average Cost of Cap	7.30	7.90	7.98	8.12	8.59	9.22	9.65	9.08	7.84	8.34	7.81

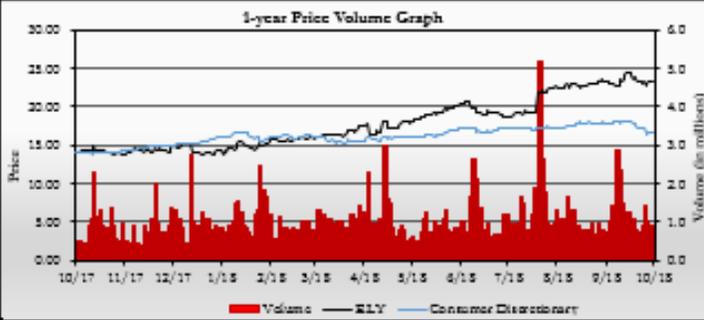
Conclusion:

Callaway is poised to come off a historic 1H. The industry is stabilizing, but indications increases in off course golfers and new golfers is cause for optimism. Their track record of innovative products gives cause for optimism on product releases in 2019. All three business segments have had major increases in revenue, which should continue in the 1H of 2019 because management has shown a willingness to focus on innovation and investment in the most profitable areas of the business. Callaway has continued to invest in their marketing through their pros and it has paid dividends. Management has confidence in their company by committing to more stock repurchases. Finally, the ROIC/WACC correlated with the success of the stock price.

Expected Case:



Callaway Golf Company (ELY)
CENTER FOR GLOBAL FINANCIAL STUDIES
BULLISH
Analysis by Eric Munn
 10/15/2018

Current Price:
Dividend Yield:
\$23.28
0.2%
Intrinsic Value
Target Price
\$26.00
\$27.93
Target 1 year Return: 20.15%
Probability of Price Increase:


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	May 8, 2018
Next earnings date	October 22, 2018
Market Assumptions	
Estimated Equity Risk Premium	5.73%
Effective Tax rate	24%

Market Data	
Market Capitalization	\$2,198.56
Daily volume (mil)	0.61
Shares outstanding (mil)	94.44
Diluted shares outstanding (mil)	97.03
% shares held by institutions	94%
% shares held by investment Managers	76%
% shares held by hedge funds	9%
% shares held by insiders	1.27%
Short interest	8.04%
Days to cover short interest	6.63
52 week high	\$24.67
52 week low	\$13.49
Volatility	26.43%

Quarter ending	Revenue	EBITDA
6/30/2017	3.45%	14.98%
9/30/2017	15.70%	1212.02%
12/31/2017	4.73%	-12.34%
3/31/2018	8.09%	24.30%
6/30/2018	7.11%	17.23%
Mean	7.82%	251.24%
Standard error	1.0%	11.8%

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-Rating)	--0.05%
Credit Model Score (Non-Rating)	--bbb-

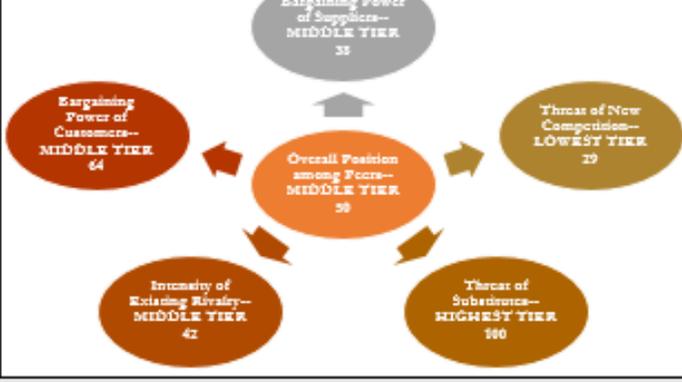
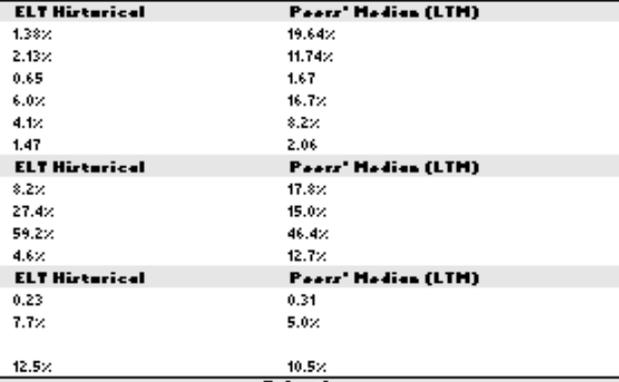
Industry and Segment Information	
LTM Revenue by Geographic Segment	LTM Revenue by Business Segment
United States--54%	Golf Clubs (Excluding Golf Accessories/Other)
Europe--13%	Golf Balls--15%
Japan--19%	Golf Accessories/Other--23%
Rest of Asia--7%	--
Other Foreign Countries--6%	--

Management	Position	Total Compensation Growth	Stock Price Growth During Tenure
Brewer, Oliver	President, CEO & Director	3.26% per annum over 5y	5.7% per annum over 5y
Lynch, Brian	Senior VP, CFO, Chief Ethics Officer, General C	27.87% per annum over 3y	14.44% per annum over 3y
Leparky, Mark	Senior Vice President of Global Operations	15.08% per annum over 4y	1.25% per annum over 4y
Arnett, Richard	Senior Vice President of Global Marketing		0% per annum over 0y
Hacknell, Alan	Senior Vice President of Research & Developm	-100% per annum over 2y	22% per annum over 2y
Thamar, Jennifer	VP & Chief Accounting Officer		

Peer	Peer
Acushnet Holding Corp.	Vista Outdoor Inc.
Malibu Boats, Inc.	Brunswick Corporation
Nautilus, Inc.	Jakobson Outdoor Inc.
Mizuno Corporation	Technogym S.p.A.
MOBO Holding, Inc.	Marine Products Corporation



Profitability	ELY (LTM)	ELY Historical	Peer's Median (LTM)
Return on Capital (GAAP)	15.8%	1.38%	19.64%
Operating Margin	12%	2.13%	11.74%
Revenue/Capital (GAAP)	1.27	0.65	1.67
ROE (GAAP)	12.8%	6.0%	16.7%
Net margin	7.6%	4.1%	8.2%
Revenue/Book Value (GAAP)	1.690897824	1.47	2.06
Invested Funds	ELY (LTM)	ELY Historical	Peer's Median (LTM)
CapEx/Capital	9.6%	8.2%	17.8%
HW/Capital	21.9%	27.4%	15.0%
Operating Asset/Capital	63.2%	59.2%	46.4%
Goodwill/Capital	5.3%	4.6%	12.7%
Capital Structure	ELY (LTM)	ELY Historical	Peer's Median (LTM)
Total Debt/Market Capitalization	0.16	0.23	0.31
Cost of Debt	11.2%	7.7%	5.0%
CGFS Rating (1=care, 2=care, and default Probability)	BBB		
WACC	51.9%	12.5%	10.5%



Forecast Assumptions	Explicit Period (6 years)	Continuing Period
Revenue Growth CAGR	4%	2.5%
Average Operating Margin	14%	13%
Average Net Margin	10%	9%
Growth in Capital CAGR	8%	3%
Growth in Claims CAGR	0%	3%
Average Return on Capital	9%	6%
Average Return on Equity	9%	6%
Average Cost of Capital	9%	9%
Average Cost of Equity	9%	9%