Gilford Securities Golf Industry Research

2010 PGA Merchandise Show Report Part One

January 27-30 2010
Orange County Convention Center

PGA 2010 MERCHANDISE SHOW

We attended the 2010 PGA Merchandise Show and came away with the following observations. We hope you find them illuminating, but we also hope you find the discourse entertaining. We welcome any and all feedback. We KNOW we will hear the feedback when you disagree. It goes with the territory. This is Part 1 of the report. Part 2 will follow with the Equipment review.

1. **Last Year's Scorecard**

Before we jump into 2010, we have to experience some self-examination by scoring our discussion from last years report. We will list some of our most important conclusions and decide how well we did. In this case, we will be the official scorekeeper and we will sign the card at the end.

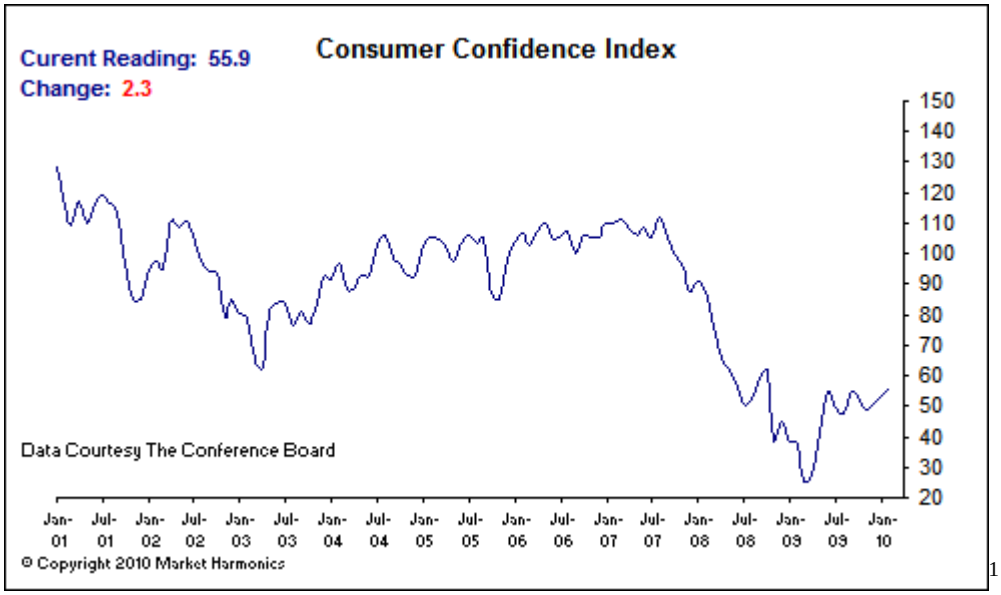
- **"The core golfers come from a better economic position and will recover faster than the average consumer**, and when they do they are **likely to exhibit pent up demand for equipment** very quickly. The bad news is that in our opinion the equipment industry is not likely to feel this in a major way until 2010, even if the economy starts to recover sooner than that."

With golf equipment sales down approximately 15% in 2009, our assessment that the equipment industry was not likely to feel this in a major way until 2010 certainly understated the point. The industry has been very stable (+ or – 1-2% for a decade) that a year down 15% was far more than we had foreseen. **Our score here is 90. Bogey golf.** We broke 100 because we deferred to 2010. We made lots of bogies because we didn't foresee anything like down 15%.

- "In late April, as banks start reporting their 1st quarter results, we will hear quotes from earnings conference calls such as "It's starting to feel a little bit better, a little more stable***". When that happens, consumer confidence will have***

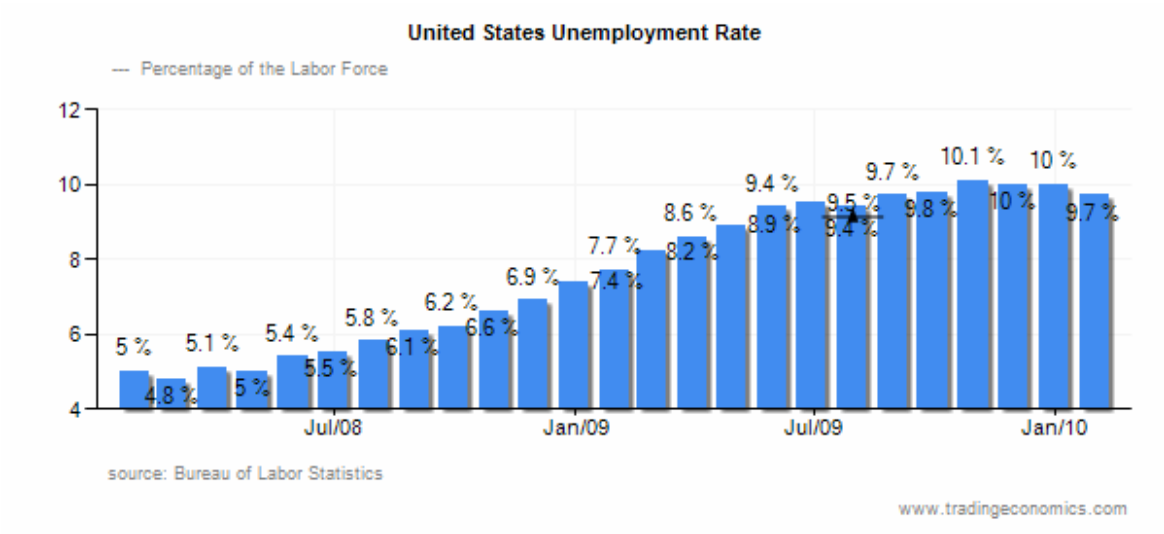
bottomed, and likely residential real estate values as well. Unemployment will continue to rise, because it always lags the bottom of the cycle."

We would remind readers that we published these prognostications on February 13th, 2009, a month before the stock market bottomed in March. It is clear looking at the chart of the Consumer Confidence Index that consumer confidence bottomed even slightly before 2009 Q1 EPS reports came in. It was more likely that consumer confidence began to rebound at the same time as the market, but it was coming from very low levels:



[1]

Our point that unemployment would continue to rise appears to have been right on the mark. In fact, as the table below make apparent, unemployment just now gives the appearance of beginning to level, and perhaps even decline somewhat. **So on this score we are shooting a 75, just a few over par.**:



[2]

[1] http://www.market-harmonics.com/free-charts/sentiment/consumer_confidence.htm
[2] http://www.tradingeconomics.com/Economics/Unemployment-rate.aspx?Symbol=USD

- ***"By the middle of the 4th quarter, our guess is that you will see 3-5 major institutions repaying the TARP money so they can pay the senior executives their bonuses."***

  This is our favorite one of all. When we made this prediction we heard nothing but derisive hoots and catcalls suggesting we had lost our mind. At the time, financial institutions were perceived as trying to keep their doors open, not repaying TARP. It was thought that it would take *years* for major financial institutions to repay the TARP loans. Instead, on March 31st, 2009 the first bank repaid the TARP. **By the end of June, ten institutions that had borrowed over $1 billion had repaid TARP**, topped off by the J.P. Morgan Chase $25 billion repayment![3] On this score we figure we shot 69 and earned a few 'You Da Man's' along the way.

- "Since something close to 65% of all sales occurs in the first half of the year, the seeds of recovery being sown in late April or early May are just too late to capitalize on. Because the industry has set the bar so low, the retail distribution channel has cut way back on the open-to-buy lines in fear of getting caught with any inventory." "The equipment manufacturers are likewise keeping inventory in the channel as lean as possible."

  We were right, but we simply did not foresee the degree of consequences that were created by this dynamic. Sales at retail were down 15%, and the retail distribution channel took their base inventories down another 10% beyond that. **The effect on the golf equipment manufacturers was devastating.** Simply put, golf equipment companies that did better than down 20% for the year outperformed the market. But **the degree of discounting that took place in 2009 was heretofore unheard of**. In what we have often described as the 'Steel Cage Battle Royale' for market share, two companies basically have been thrown from the ring; Nickent Golf has been dissolved and MacGregor Golf has fallen into the clutches of Golfsmith and is now a proprietary brand. **Our score here is 100.** We saw it, and yet we did not know what it would turn out to mean. What an analytical hacker.

- "We would characterize the last decade as the Tiffany's and Coach decade. That decade is dead. Technological innovation with a value proposition will be the new mantra."

  The value proposition is the new mantra. In fact, it's the only mantra. Score this one a 72. Right on par.

- "Golf's symbol of the Tiffany/Coach era is membership in a country club. Many private facilities are going to find that they need to make several structural long term changes to their economic model or risk insolvency."

  This trend didn't start with the recession, nor will it end with the recovery. This is a long term trend. The National Golf Foundation reported that 49.5 courses opened in the U.S. in 2009, but 139.5 closed, leaving the U.S. with a net of 90 courses less at the end of 2009 versus 2008. On top of that, 30 courses changed from public to private, while 96 changed from private to public. This leaves the U.S. with 66 less private golf courses at the end of 2009 versus 2009, not counting the private facilities that outright closed. The best we can say is that the trend continues. Many have suggested that golf would be healthier if the number of courses contracted faster. We are of the opinion that there is no such thing as a healthy sport that is reducing the availability of facilities that it can be played at. The operators need to find ways to accomplish better utilization rates. Shrinking the stock is not a sign of health. We get no score on this point, as this was the identification of a trend that has been in place for years.

[3] http://www.ibanknet.com/scripts/callreports/filist.aspx?type=tarprepayment

Final Score on 2009

If we total up all our scores and average them we get 81.2. So as prognostication go, call us about a nine handicapper. When is comes to predicting the future, we are a coin flip. That being said, let's head to 2010 and see what we think:

2. **2010 Prognostications for the Golf Equipment Industry.**

- **Cracking the Bullwhip on the Golf Equipment Industry Suppliers**

While attending the PGA Merchandise Show we had meeting with over 20 senior executives in the golf industry including OEM's, suppliers, retail distribution channel partners and service providers. **The OEM's came off like the Stepford wives. To a company they espoused the collusive mantra of 'cautiously optimistic' on the prospects for 2010.**

Yet we found a curious phenomenon as we worked our way towards each end of the channel. The retail channel partners were conceding that their Q4 inventory levels were brought as low as possible so they could produce balance sheets that appeared as liquid and healthy as possible. Mission accomplished. **The retail channel partners were suggesting that they were taking the annual sell-in of hard goods plus doing some restocking of inventory**. Thus the order patterns to the OEM's were better, and this was leading the OEM's to their 'cautiously optimistic' tone. We now read 'cautiously optimistic' to mean '2010 Q1 orders from retail are better than expected, but we don't want to get too enthusiastic until we see how the sell through goes'.

This has led to a curious phenomenon that has occurred as we back up into the supply side of the business. A couple weeks ago the Wall Street Journal ran an article about Caterpillar and **the bullwhip effect of their ordering patterns on their suppliers**.[4] This article could easily have applied to the suppliers of the golf equipment industry. Last year, when the sell through did not materialize, orders to the suppliers of components, shafts, grips, head covers, packaging and the like slowed to a crawl. These suppliers, all located in a tight regional area in China, proceeded to downsize their labor forces by as much as one-third. Now, **as the OEM's are retuning to more normal ordering patterns compounded by the restocking of the retail distribution channel, the stress on the suppliers to meet this demand is extreme.** We spoke to supplier after supplier that is running 24 hours a day/ 7 days a week to try to keep up. Their efficiency ratios are off the charts because they are all still running with 1/3 less employees. **As the suppliers have gone to try to rehire the employees that they laid off last year, *they can't find them*!** Apparently, these employees which came from primarily rural areas of China, have matriculated into urban settings and found jobs in the service sector.

The employees that are still there in the supply side are beginning to be run ragged. You can only run flat out for so long before production problems and accidents begin to crop up. ***If there is any meaningful sell-through this year, we could easily see supply-side bottlenecks.*** **This will work to the advantage of the larger equipment companies**, because they will be able to carry larger inventories on their balance sheets and they will have first call on the supplies that are available.

- **The Consumer: Not Free Spending, but Not in Free Fall**

So much of how 2010 turns out depends upon the condition and state of mind of the consumer. The state of mind of the golf consumer could hardly have been worse during the key selling season last year. The Dow Jones Industrial Average made an inter-day low below 6500 on March 6th, just as the key selling season was preparing to move into full swing. As you can see from The Consumer Confidence index chart above, the index has risen steadily since bottoming out early last year.

[4] http://online.wsj.com/article/SB10001424052748704509704575019392199662672.html

Clearly, **last year heading into the key selling season, the consumer was in free fall**, and the consumer's reticence to spend was exacerbated by brokerage accounts that suffered enormous damage with no certainty that a bottom had been found or that the financial system as constructed was viable.
Looking at the index today, **it is clear that the consumer has not returned to free-spending mode. But *the consumer is clearly no longer in free fall.***

We were invited to the Sports Illustrated Golf Group breakfast meeting at the PGA Show and we listened to a presentation from Jon Last of the Sports & Leisure Research Group entitled 'The Golfer's Mindset 2010: *Moving Out of the Rough'*.[5] Sports & Leisure Research Group conducted online surveys of over 1,000 golfers last January, last July and this January. The results were quite revealing. Last January, before the real bottom of the market, 80% of those surveyed suggested that they intended to spend the same or more on golf in 2009 versus 2008. By the July survey, after the bottom, that number had crumbled to 59%. This most recent January saw the number beginning to rise, up to 66%. By itself, this number could be interpreted as better, but not that great. But ***we need to remember that golfers are a special impulsive breed. The more they are at the course, the more they end up wanting to spend.***

Last January Sports & Leisure Research identified that 77% of golfers intended to *play* as much or more in 2009 versus 2008. Looking back, 72% actually did play as much or more in 2009 versus 2009, so there is decent correlation to the predictive nature of the survey. This January, ***94% report that they expect to play as much or more in 2010*** versus 2009. **The likelihood is that, if a greater percentage of golfers are going to be at golf courses the same amount of time or more, then more is going to get spent on golf.**

After all, when we listened to The State of the Industry presentation from Jim Koppenhaver of Pellucid Corp[6] and Stuart Lindsay of Edgehill Golf Advisors[7], we learned that the number of golfers were statistically flat and that the number of rounds played were statistically flat, but the brunt of the pain had fallen on the backs of the golf course operators who had engaged in discounting to keep the numbers up. Certainly there had been extraordinary discounting by golf equipment companies as well. For a successful 2010, we are going to need the equipment companies to 'take the needle out of their arm' as it were. **The Pellucid/Edgehill report suggested that golf has lost 'committed and involved' participants and now has more 'casual' participants, but if close to 90% of the golfers out there play as much or more in 2010 versus 2009, *it is possible that the 'committed and involved' group could regain some ground.***

Certainly an improvement in unemployment statistics would further improve the consumer mindset. We would note from the unemployment chart above that the rate of increase in unemployment appears to be flattening out, if not declining. **Were unemployment begin to measurably decline, this would have a beneficial impact on consumer confidence.**

[5] http://www.sportsandleisureresearch.com/

[6] http://www.pellucidcorp.com/

[7] http://www.edgehillgolfadvisors.com/

Summary

We understand the need for golf equipment CEO's to be cautious. At the same point in time, suppliers work off of purchase orders. Suppliers in Asia have been working overtime for months now.[8]

Taiwan's Top 3 Golf Club Head Makers to See Busy Month in Feb.

2010/02/05

Taipei, Feb. 5, 2010 (CENS)--With a great deal of contract orders on hand, Taiwan's top three golf club head makers, namely Advanced International Multitech Co., Ltd., O-TA Precision Industry Co., Ltd. and Dynamic Precision Industry Corp., will all experience a busy month in February.

To take advantage of the recent global market recovery, large-sized international brands of golf clubs, such as TaylorMade, Nike, Callaway, Ping and Bridgestone, have actively raised their inventories and sharply increased contract orders for golf club heads with their suppliers.

Amid the market booms, Dynamic Precision and Advanced International have garnered contract orders worth NT$160 million (US$5 million at US$1: NT$32) and NT$800 million (US$25 million), respectively, so far. Also, O-Ta has secured orders worth around NT$400 million (US$12.5 million).

Advanced International has planned to adjust its labor and production schedules at its factory in China to fill flood of contract orders in February, while O-Ta and Dynamic Precision have also decided to reduce workers` holidays to step up production.

To cope with to comparatively fewer working days in February, which will witness over one week of Chinese New Year holidays, the three companies have purposefully controlled their production lines and slowed reception of orders to reduce the risk of shipment delays.

(by Steve Chuang)

Put this together with the improvement in consumer sentiment and the fact that golfer's intentions are far better than last year, and we feel certain that the first quarter will be vastly improved for the golf equipment companies. Simply stated, the traditional sell in of equipment during the first quarter, plus some inventory restocking at the retail distribution channel end, is leading to improved order patterns for golf club equipment.

There are still big questions to be sure. How robust will the sell through at retail be? That requires consumer confidence to continue to rise, and unemployment to begin to fall. Can the industry take the needle out of its own arm and reduce the amount of cannibalistic discounting that goes on? TaylorMade is opening the year off with a $250 driver. That's not exactly an encouraging sign from the market leader in the driver category, even if the strategy is "My competitor is drowning, so I am going to stick a garden hose down his throat."

The return of Tiger Woods would certainly do a lot for golfer's personal sentiment. He is the most popular players out there, despite his troubles. The game needs him back.

Stay tuned for Part 2 of our report: The golf equipment review.

[8] http://news.cens.com/cens/html/en/news/news_inner_31157.html

ANALYST CERTIFICATION

I, Casey Alexander, certify that all the views expressed in this research report accurately reflect my personal views of the subject company (ies). I also certify that I have not and will not receive compensation with respect to the issuance of this report.

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Callaway Golf is rated a Buy. No other company mentioned here is currently rated by Gilford Securities, Inc.

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Buy The stock should outperform its industry or peer group by 20% or greater within a 12-18 month time frame.

Sell The stock is expected to under-perform its industry or peer group by 20% or greater within a 12-18 month time frame, or where fundamentals of a company have deteriorated significantly and the stock is expected to materially depreciate.

Hold The stock does not have enough upside or downside potential to rate a Buy or Sell. The stock is either fairly valued or has too much uncertainty to have a Buy or Sell rating.

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Casey Alexander
Special Situations Analyst
Gilford Securities, Inc.
777 Third Ave., 17th Floor
NYC, NY 10017
212-940-9276
Cell 516-313-8728
c.alexander@gilfordsecurities.com