

Buy

Price:	\$7.85
Price Target:	\$9
52-week High/Low:	\$9.35-\$4.66
Diluted Shares Out. (MM):	63.2
Enterprise Value (MM):	\$415
Dividend/Yield:	\$0.04-.5%
Average Daily Vol. (MM):	1,281
EV/2009E Revenue:	.42
NetDebt/ Capital:	0%
Tangible Book Value/Share:	\$6.27

EPS	2008A	2009	2010E
Mar.	\$.61	\$.12A	\$0.34
Jun.	\$.63	\$.12A	\$0.32
Sep.	(\$0.08)	(\$0.25)A	(\$0.11)
Dec.	(\$0.24)A	(\$0.27)A	(\$0.18)
Fiscal Year	\$.94A	\$(.27)A	\$0.37E


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Callaway Golf: (NYSE: ELY)

Putting All the Inputs Together; Reiterate Buy Rating

INVESTMENT SUMMARY

Callaway Golf (ELY) Reported last week, followed by our annual trip to the PGA Merchandise Show in Orlando, Florida. What follows is our impression of ELY's 2009 Q4 report, our judgment of where the industry is currently, and our assessment of how the year is likely to play out with particular emphasis on 2010 Q1.

1. 2009 Q4 All Time Record Revenues

The best kept secret about ELY's 2009 Q4 report was that **they produced the highest revenues (\$185 MM, 9% above our estimate) for any Q4 in the history of the company**. It is almost eerily strange that management missed the opportunity to stand on their soapbox and scream to the world this impressive achievement. After all, the golf industry in general is a group of highly self-congratulatory folks and this is the kind of compensation-justifying news that can hardly go undeclared. Yet it did. As far as we know, not one other analyst picked up on this tidbit either.

Perhaps the reasoning this record achievement went by without the attendant pomp & circumstance is because **ELY produced 31.3% gross margins for the quarter (versus our estimate of 34.7%)**. This was not record low margins, but it wasn't anything to crow about for sure, as the end result was EPS adjusted for recurring one-time charges of a loss of (\$0.27) per share. We say recurring one-time charges because the Gross Margin Initiatives seem to have a half-life longer than uranium.

There was a **nice increase of sales to Japan** in Q4 (up \$15MM), and there was a **corresponding increase in putter sales** in the quarter (up \$14MM). When we inquired, we were told that there was a very strong increase in sales of the White Ice putter lines into Japan for holiday sales. Since this line is new, we inquired as to why there would still be such a drag on gross margins as the White Ice line is new and presumably carrying a better margin, not a worse margin.

Description. Callaway Golf Company (Callaway Golf), together with its subsidiaries, designs, manufactures and sells golf clubs (drivers, fairway woods, hybrids, irons, wedges and putters) and golf balls. The Company generally sells its products to golf retailers (including pro shops at golf courses, as well as off-course retailers), sporting goods retailers and mass merchants, directly and through its wholly-owned subsidiaries, and to third-party distributors.

We thought perhaps there had been some sort of discount deal for volume. Instead we were told that as product is shipped to one distribution point it gets marked to a Yen spot market. Then as it gets forwarded on to the end customer and gets paid for, it gets remarked to the Yen spot market. In between points one and two, **an adverse Yen/US\$ relationship apparently cropped up and damaged some of the margin on the business.** To be perfectly honest, we tried but we really don't quite understand it. Chances are pretty good we aren't even explaining it right, and the Company has chosen not to quantify it.

2. Supply Side Economics

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. We also noted that Callaway's year-ending inventory level was also the lowest in the last five years. **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. Last week the Wall Street Journal ran an article about Caterpillar and the bullwhip effect of their ordering patterns on their suppliers.¹ 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.

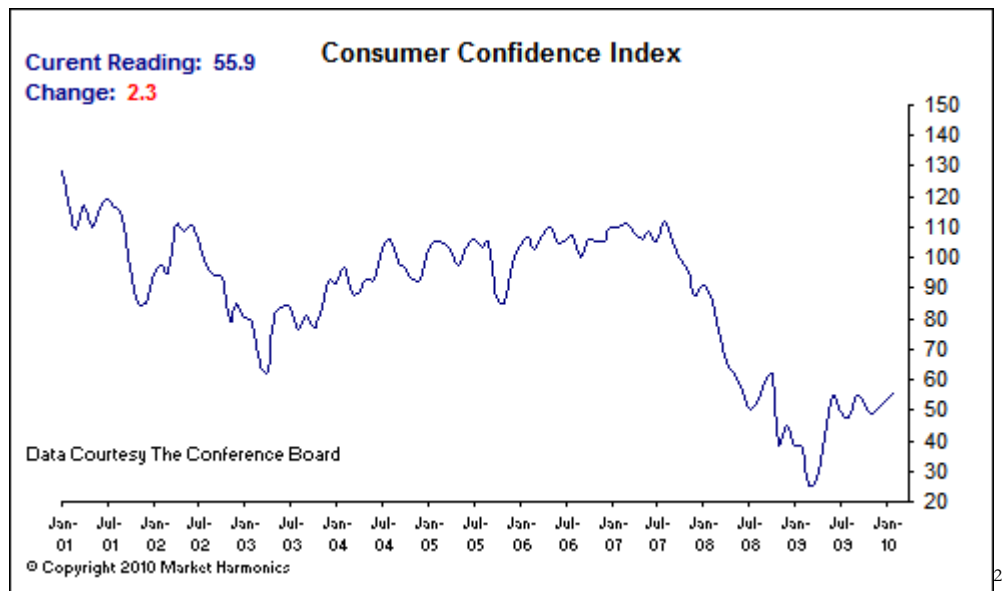
The employees that are still there in the supply side are beginning to be run ragged. You can only run flat out for so long before production problems and accidents begin to crop up. ***If there is any meaningful sell-through this year, we could easily see***

¹ <http://online.wsj.com/article/SB10001424052748704509704575019392199662672.html>

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.

3. 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. The Consumer Confidence index has risen steadily since bottoming out early last year.



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*".³ 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

² http://www.market-harmonics.com/free-charts/sentiment/consumer_confidence.htm

³ <http://www.sportsandleisureresearch.com/>

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.**

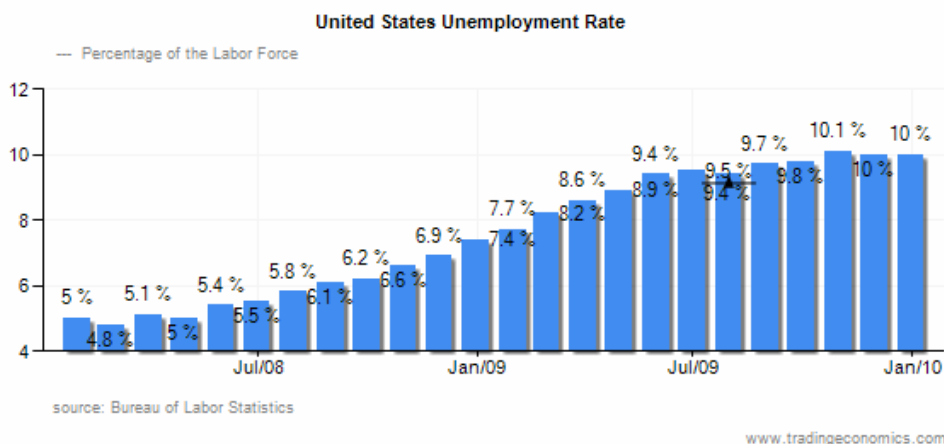
After all, when we listened to The State of the Industry presentation from Jim Koppenhaver of Pellucid Corp⁴ and Stuart Lindsay of Edgehill Golf Advisors⁵, we learned that the number of golfers were statistically flat and that the number of rounds played were statistically flat, but the brunt of the 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 and table below⁶ that the rate of increase in unemployment appears to be flattening out. Were unemployment begin to measurably decline, this would have a beneficial impact on consumer confidence.

⁴ <http://www.pellucidcorp.com/>

⁵ <http://www.edgehillgolfadvisors.com/>

⁶ <http://www.tradingeconomics.com/Economics/Unemployment-rate.aspx?Symbol=USD>



Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2009	7.70	8.20	8.60	8.90	9.40	9.50	9.40	9.70	9.80	10.10	10.00	10.00
2008	5.00	4.80	5.10	5.00	5.40	5.50	5.80	6.10	6.20	6.60	6.90	7.40
2007	4.60	4.50	4.40	4.50	4.40	4.60	4.60	4.60	4.70	4.70	4.70	5.00
2006	4.70	4.80	4.70	4.70	4.60	4.60	4.70	4.70	4.50	4.40	4.50	4.40

4. Putting It All Together for 2010

Trying to divine the full year for 2010 is a difficult exercise at best. Callaway offered guidance for the full year that includes the following prognostications:

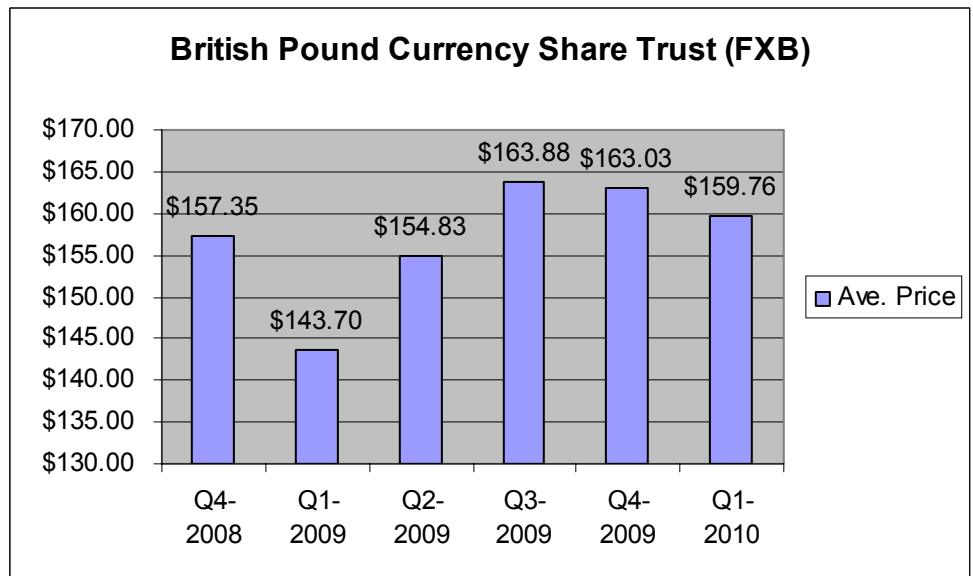
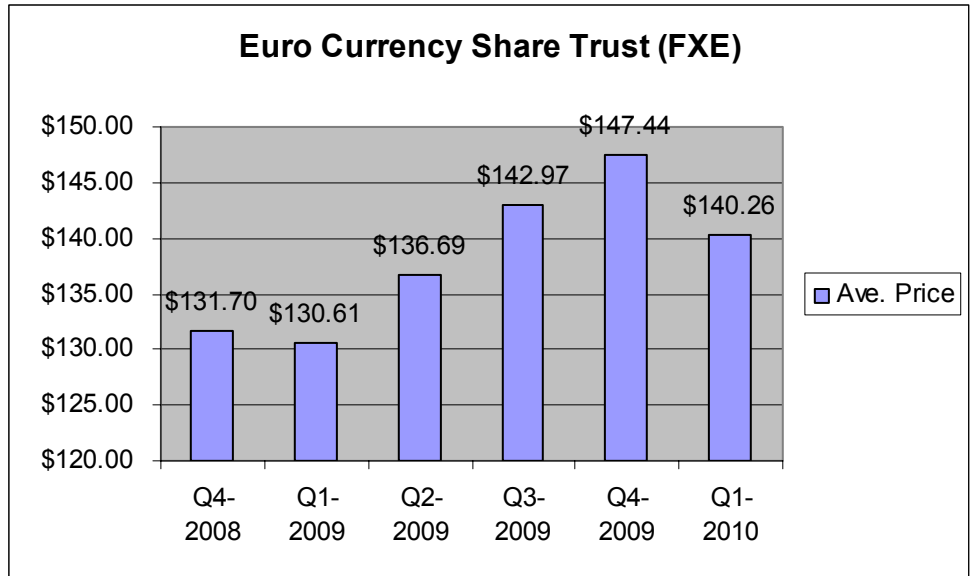
- **Revenues of \$990MM - \$1.05 billion**
- **Gross Margins between 42% and 44%**
- **OpEx of \$375MM - \$405MM**
- **Full Year EPS of \$0.25 - \$0.35 per share**
- **Recurring onetime charges of \$0.10 per share**

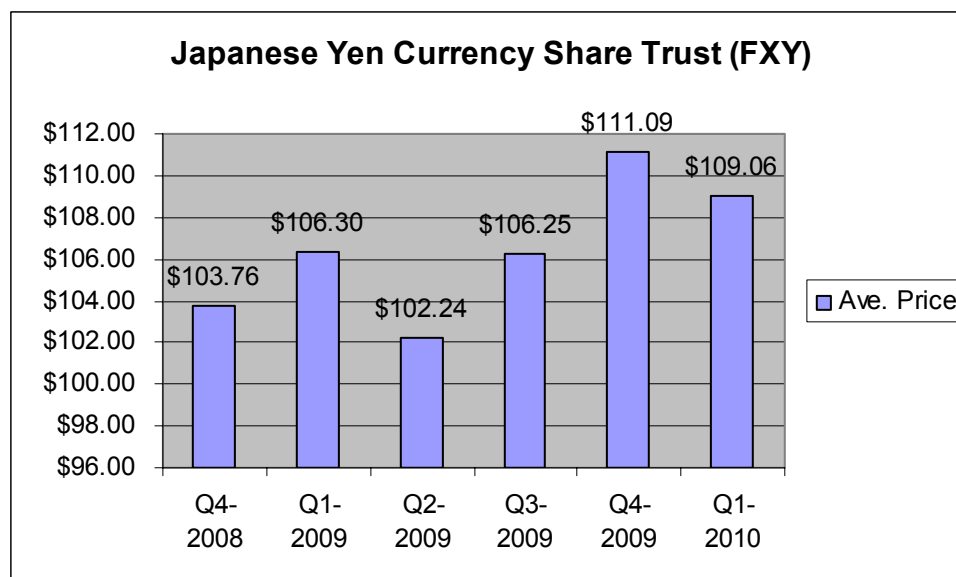
We have at least a Machiavellian reason to believe that it is in management’s best interests to be ultra conservative with their full year guidance. Visibility beyond Q1 is not great. Economic trends globally, as well as changes on forex rates, will have a large impact on the actual results. As well, Q4 results were released after the close on January 26th. We found it fascinating to note that management’s incentive stock options were priced to the market close on January 28th. The lower the price of the stock is on the 28th, the better chance for management to make a decent return. ELY shares closed over 5% lower on the 28th of January than they did on the 26th of January. We concede that it is certainly in the best interests of management to be conservative with their full year outlook. It may actually be in the best long term interests of the performance of the stock as well. Time will tell.

What we do know is that based upon the multiple inputs we have gathered over the last few months, we have every reason to believe that 2010 Q1 is going to be better than Street expectations. Our inputs include but are not limited to:

- **Very positive Forex relationships in key currencies versus 2009**

We will let the charts do the talking here:





Clearly the positive forex relationships will add significant margin to Q1 sales. The Euro is running 7% better than 2009, the British Pound is running 11% better, and the Japanese Yen is running about 3% better. Forex was a huge penalty on Callaway revenues and margins in 2009 in every quarter except for Q4. To see this swing in the other direction suggests much better results in 2010 Q1, on a simple apples-to-apples comparison.

- **Suppliers work on purchase orders, and they are working overtime**

We explained what was happening with the suppliers to the golf equipment industry. Certainly this is part normal sell-in demand fill, but there is definitely some inventory restocking in the retail distribution channel going on beyond the normal sell-in demand fill. Some suppliers are reporting all time record months. We would encourage investors to follow the footnoted link to find the reports of demand with the major component manufacturers in Asia.⁷

- **Better consumer sentiment**

Consumer Confidence Indexes are up from the lows. A very high percentage of golfers surveyed expect to play the same or more than last year (94%). A growing percentage of golfers expect to spend the same or more than last year (66%). Unemployment rates appear to be peaking out, and if they begin to decline, could improve consumer sentiment even more.

- **Management did not guide Q1**

We find it curious that ELY management chose to guide to the full year, but not to Q1. Presumably, in an industry where visibility is limited, their visibility into the potential 2010 Q1 results would have been much clearer than the visibility into the full year. Once

⁷ http://news.cens.com/cens/html/en/news/news_inner_30742.html

again, given the impending option grants due two days after reporting, if Q1 looked robust, why let the cat out of the bag? Let the results speak for themselves when the time comes.

- **The return of Tiger Woods**

Press reports have suggested that Tiger may be coming back fairly soon. Some reports have said he could return in as little as two weeks. If true, it can't hurt.

5. Positive EPS Surprise for 2010 Q1

We think that when you put all these inputs into the mix, we arrive at a strong degree of confidence that ELY is going to produce a positive EPS surprise for 2010 Q1. The current consensus estimate for Q1 is \$0.25 per share, with a top side estimate of \$0.30 per share. The top side estimate is ours.

We are raising our 2010 Q1 EPS estimate from a Street high \$0.30 per share to a Street higher \$0.34 per share. We are raising our revenue estimate from \$300MM to \$315MM for Q1.

We are going to pull Q2 down from \$0.37 per share to \$0.32 per share. We are dropping our revenue estimate from \$325MM to \$315MM. Since we are now going to apply the treasury method to calculating EPS, the reduction in shares outstanding results in larger losses per share in Q3 and Q4, so in the aggregate our full year estimate is going to come down to \$0.37 per share from \$0.44 per share. This full year estimate is still above the top end of the Company's guidance.

Clearly, we think investors need to get involved now to benefit from what we see as an upside surprise in Q1. We also think there is a catalytic lift possible from any return to the PGA Tour by Tiger Woods. It would certainly focus the world's eyes on the golf world.

6. Reiterate Buy Rating

Callaway currently sells at 21X our 2010 full year estimate of \$0.37 per share. This may not be extraordinarily cheap, but the shares are also trading at a 25% premium to tangible book value which is certainly not expensive. Since we are projecting full year earnings higher than company guidance, we expect management to be increasing guidance on top of the Q1 positive EPS surprise. We see this as a catalytic event for appreciation of the shares. Our price target remains \$9 per share, 24X our full year estimate. We sense that the shares could run into resistance at the \$10 level, as this is the area where the Company can call for mandatory redemption of the convertible preferred shares.

The potential return of Tiger Woods to active status could also be a positive catalytic event for the shares. A potential negative would be a quick resumption of the discounting that plagued the market in 2009.

Risks to Achieving the Price Target

FX comparisons could move adversely causing reductions in revenues and gross margins.

New products could fail to resonate with consumers. There could be a resumption of the product discounting that could impact margins and EPS.

Global and domestic economic conditions could deteriorate further creating a negative environment for consumer discretionary products.

The number of golfers and rounds played could decline, reducing the size of the overall market. Weather could also have a negative impact on golfer's willingness or ability to play, thus negative impacting club and ball sales as well as accessories.

Any number of unanticipated events could result in less sales and weaker results.

**CALLAWAY GOLF
INCOME STATEMENT**

(in thousands, except per share data)

	2009E		Q1E 2010		Q2E 2010		Q3E 2010		Q4E 2010		2010E	
	AMT	%	AMT	%	AMT	%	AMT	%	AMT	%	AMT	%
Net sales	\$ 950,799	100%	\$ 315,000	100.0%	\$ 315,000	100%	\$ 190,000	100%	\$ 175,000	100%	\$ 995,000	100%
Cost of goods sold	\$ (600,880)	-63.2%	\$ (170,100)	-54.0%	\$ (173,250)	-55.0%	\$ (112,100)	-59.0%	\$ (105,000)	-60.0%	\$ (560,450)	-56.3%
Gross profit	\$ 349,919	36.8%	\$ 144,900	46.0%	\$ 141,750	45.0%	\$ 77,900	41.0%	\$ 70,000	40.0%	\$ 434,550	43.7%
Selling expenses	\$ (260,597)	-27.4%	\$ (76,000)	-24.1%	\$ (75,000)	-23.8%	\$ (57,000)	-30.0%	\$ (56,000)	-32.0%	\$ (264,000)	-26.5%
General and administrative expenses	\$ (81,487)	-8.6%	\$ (21,000)	-6.7%	\$ (21,000)	-6.7%	\$ (21,000)	-11.1%	\$ (21,000)	-12.0%	\$ (84,000)	-8.4%
Research and development costs	\$ (32,213)	-3.4%	\$ (7,500)	-2.4%	\$ (7,500)	-2.4%	\$ (7,500)	-3.9%	\$ (7,500)	-4.3%	\$ (30,000)	-3.0%
Reconciling Items	\$ -		\$ -		\$ -		\$ -		\$ -		\$ -	
Income (loss) from operations	\$ (24,378)	-2.6%	\$ 40,400	12.8%	\$ 38,250	12.1%	\$ (7,600)	-4.0%	\$ (14,500)	-8.3%	\$ 56,550	5.7%
Interest and other income, net (Note 11)	\$ 931	0.1%	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%
Income (loss) before income taxes and cumulative effect of accounting change	\$ (23,447)	-2.5%	\$ 40,400	12.8%	\$ 38,250	12.1%	\$ (7,600)	-4.0%	\$ (14,500)	-8.3%	\$ 56,550	5.7%
Income tax (provision)/benefit	\$ 11,921	1.3%	\$ (15,554)	-4.9%	\$ (14,726)	-4.7%	\$ 2,926	1.5%	\$ 5,583	3.2%	\$ (21,772)	-2.2%
Preferred Stock Dividend	\$ (5,688)		\$ (2,625)		\$ (2,625)		\$ (2,625)		\$ (2,625)		\$ (10,500)	
Income before Acct./Acquisition Charges	\$ (17,214)	-1.8%	\$ 22,221	7.1%	\$ 20,899	6.6%	\$ (7,299)	-3.8%	\$ (11,543)	-6.6%	\$ 24,278	2.4%
Accounting/Acquisition charges; net of tax	\$ (3,734)	-0.4%	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%	\$ -	0.0%
Net income (loss)	\$ (20,948)	-2.2%	\$ 22,221	7.1%	\$ 20,899	6.6%	\$ (7,299)	-3.8%	\$ (11,543)	-6.6%	\$ 24,278	2.4%
Fully Diluted Shares Outstanding	63,176		65,000		65,000		65,000		65,000		65,000	
EPS	\$ (0.33)		\$ 0.34		\$ 0.32		\$ (0.11)		\$ (0.18)		\$ 0.37	
EPS without one-time charges	\$ (0.27)		\$ 0.34		\$ 0.32		\$ (0.11)		\$ (0.18)		\$ 0.37	

ANALYST CERTIFICATION

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

REQUIRED DISCLOSURES

In the normal course of business, Gilford Securities seeks to perform investment banking and other services for various companies and to receive compensation in connection with such services. As such, Gilford Securities intends to seek compensation for investment banking services from the subject company in the next three months.

STOCK RATINGS

- Buy:** The stock should outperform its industry or peer group by 20% or greater within a 12-month timeframe.
- Sell:** The stock is expected to underperform its industry or peer group by 20% or greater within a 12-month timeframe, or fundamentals have deteriorated significantly and the stock is expected to materially depreciate.
- Hold:** The stock does not have enough upside or downside potential to rate it a Buy or Sell. It is either fairly valued or carries too much uncertainty for a Buy or Sell rating.

Distribution of Gilford Ratings (As of 01-22-10)

Category	Coverage	IB Services*
Buy	58%	16.7%
Hold	32%	0%
Sell	10%	0%

* Percentage of companies within this category for whom Gilford has provided investment banking (IB) Services within the last 12 months.

ADDITIONAL INFORMATION AVAILABLE UPON REQUEST

Date	Rating	Price	Target
January 12, 2007	Buy	\$14.46	\$17.50
February 23, 2007	Buy	\$15.54	\$18.50
April 17, 2007	Buy	\$18.20	\$19.50
June 20, 2007	Buy	\$18.29	\$19.50
August 3, 2007	Buy	\$15.67	\$19.50
October 18, 2007	Buy	\$15.27	\$22.00
January 15, 2008	Buy	\$16.01	\$22.00
February 20, 2008	Buy	\$15.86	\$22.00
April 30, 2008	Hold	\$13.96	N/A
May 15, 2008	Hold	\$13.52	N/A
July 1, 2008	Hold	\$11.74	N/A
July 25, 2008	Hold	\$13.56	N/A
September 18, 2008	Buy	\$14.24	\$17.50
October 21, 2008	Buy	\$9.69	\$14.85
November 3, 2008	Buy	\$10.46	\$15.00
December 15, 2008	Buy	\$9.19	\$12.50
January 16, 2009	Buy	\$9.05	N/A
January 21, 2009	Buy	\$8.81	N/A
February 4, 2009	Buy	\$7.88	N/A
March 11, 2009	Buy	\$6.17	N/A
March 30, 2009	Buy	\$7.34	N/A
April 20, 2009	Buy	\$7.24	N/A
May 4, 2009	Hold	\$8.44	N/A
May 14, 2009	Buy	\$6.50	N/A
June 17, 2009	Buy	\$5.50	N/A
July 21, 2009	Buy	\$5.00	N/A
August 4, 2009	Buy	\$6.60	N/A
September 14, 2009	Hold	\$8.00	N/A
October 16, 2009	Hold	\$8.75	N/A
November 2, 2009	Hold	\$6.84	N/A
November 4, 2009	Buy	\$6.50	N/A
November 10, 2009	Buy	\$6.76	\$9.00
November 10, 2009	Buy	\$7.04	\$9.00
January 7, 2010	Buy	\$8.03	\$9.00
February 3, 2010	Buy	\$7.85	\$9.00

