

October 14, 2008

Key Metrics

ELY - NYSE	\$12.00
Pricing Date	10/13/2008
Price Target	\$16.00
52-Week Range	\$18.20-\$9.78
Shares Outstanding (mm)	64.8
Market Capitalization (\$mm)	\$777.6
3-Mo Average Daily Volume	848,101
Institutional Ownership	82%
Debt/Total Capital	17.8%
ROE	11.4%
Book Value/Share	\$9.73
Price/Book	1.2x
Dividend Yield	2.3%
LTM EBITDA Margin	12.67%

EPS(\$) FY: December

	2007A	Prior 2008E	Curr. 2008E	Prior 2009E	Curr. 2009E
1Q-Mar	0.48	--	0.61A	0.68E	0.63E
2Q-Jun	0.55	--	0.63A	0.69E	0.65E
3Q-Sep	0.06	0.00E	(0.04)E	0.10E	0.05E
4Q-Dec	(0.24)	(0.17)E	(0.21)E	(0.18)E	(0.19)E
FY	0.89	1.08E	1.00E	1.30E	1.14E
P/E	13.5x		12.0x		10.5x

Revenue(\$mm)

	2007A	Prior 2008E	Curr. 2008E	Prior 2009E	Curr. 2009E
1Q-Mar	334.6	--	366.5A	370.0E	360.0E
2Q-Jun	380.0	--	366.0A	385.0E	365.0E
3Q-Sep	235.5	232.0E	220.0E	240.0E	230.0E
4Q-Dec	174.4	195.0E	185.0E	190.0E	185.0E
FY	1,124.6	1,159.5E	1,137.5E	1,185.0E	1,140.0E



Company Description: (www.callawaygolf.com) Callaway Golf Company, together with its subsidiaries, engages in the design, manufacture, and sale of golf clubs and golf balls. The company's products include drivers, fairway woods, hybrids, irons, wedges, putters, golf balls, golf bags, golf gloves, golf headwear, golf towels, golf umbrellas, and footwear. In addition, it licenses its trademarks and service marks in exchange for a royalty fee to third parties for use of its products.

Callaway Golf Company

Rating: Buy

International Growth Could Slow; Valuation Compelling; PT to \$16 from \$18

Investment Highlights:

- **Weakening international economy could slow sales growth.** Despite a challenging domestic market (1H sales down 7%), Callaway expanded 1H08 revenues roughly 3% with strong international growth (1H sales up 14%). With economic weakness apparently spreading overseas, a more conservative sales forecast appears warranted. Therefore, we have reduced our top-line estimates by \$22mm in 2008 and \$45mm in 2009.
- **New product releases assist 4Q and 2009 sales.** 4Q08 should benefit from a new product release, the FT-iQ (October 15 internationally - November 15th domestically). In FY09, easier domestic comps coupled with key additional new product releases should keep sales roughly flat Y/Y. In 2008, 3 of Callaway's top lines (FT-i, FT-5, and X-20 irons) are second-year products, which typically exhibit Y/Y declines. A fresher 2009 line could provide an additional buffer to offset a potentially weaker environment.
- **Margin initiatives should continue to boost profitability.** Callaway's gross margin initiative expanded gross margins 490 bp Y/Y in 2007 and appears on track for another 100 bp gain in 2008. Independent of economic conditions, the company is targeting another \$20mm to \$30mm in 2009/2010 savings.
- **Reduced estimates below current company guidance.** Current guidance is for 3% to 5% top-line growth, or FY08E EPS of roughly \$1.08, and EBIT margins expanding to the mid-teens by roughly FY11. While our revised estimates reflect trends below current near/long term guidance, we believe economic uncertainties dictate a more conservative stance. Based upon reduced sales leverage, our FY09 and FY10 EPS estimates have been reduced by \$0.08 and \$0.16, respectively.
- **Downside adjustments appear built into current price; maintain Buy rating; adjusting price target to \$16 from \$18.** We believe downside risk to current expectations is already built into Callaway's share price. The shares currently trade at roughly 5x our FTM EV/EBITDA estimate versus a peer group TTM multiple of 6.5x. Our new \$16 price target, down from \$18, reflects a similar multiple, to its peer group.
- **Price target supported by conservative LT DCF analysis.** Our \$16 price target is supported by a DCF analysis that assumes annual free cash flow of \$75mm. While 2008 expectations are for roughly \$50mm, it includes roughly \$11mm in charges and \$15mm in one-time capital expenditure increases. In 2007, Callaway generated \$119mm in FCF and longer-term expectations are for annual free cash flow of \$100mm and above.

EQUITY RESEARCH

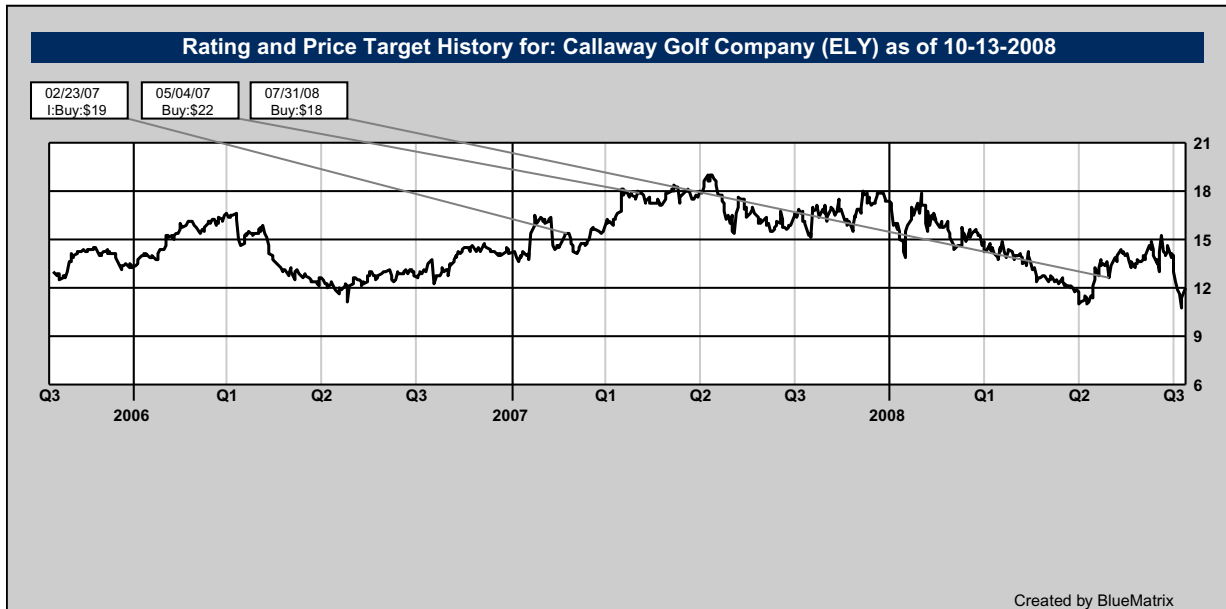
Callaway Golf (ELY)

(In Millions, Except Per Share Data)

Quarter End	FY 2006	Q1 Mar-07	Q2 Jun-07	Q3 Sep-07	Q4 Dec-07	FY 2007	Q1 Mar-08	Q2 Jun-08	Q3E Sep-08	Q4E Dec-08	FYE 2008	Q1E Mar-09	Q2E Jun-09	Q3E Sep-09	Q4E Dec-09	FYE 2009
Sales	1017.9	334.6	380.0	235.5	174.4	1124.6	366.5	366.0	220.0	185.0	1137.5	360.0	365.0	230.0	185.0	1140.0
% Increase	2.0%	10.6%	11.2%	21.6%	-3.0%	10.5%	9.5%	-3.7%	-6.6%	6.1%	1.1%	-1.8%	-0.3%	4.5%	0.0%	0.2%
Cost of Goods Sold	614.6	173.9	202.9	137.4	109.6	623.9	190.9	190.3	126.5	111.9	619.6	182.9	185.1	128.1	109.2	605.2
As % Sales	60.4%	52.0%	53.4%	58.3%	62.8%	55.5%	52.1%	52.0%	57.5%	60.5%	54.5%	50.8%	50.7%	55.7%	59.0%	53.1%
% Increase	6.9%	2.1%	1.4%	10.1%	-8.2%	1.5%	9.8%	-6.3%	-7.9%	2.1%	-0.7%	-4.2%	-2.7%	1.3%	-2.5%	-2.3%
Gross Profit	403.3	160.7	177.1	98.1	64.8	500.7	175.5	175.8	93.5	73.1	517.9	177.1	179.9	101.9	75.9	534.8
Margin	39.6%	48.0%	46.6%	41.7%	37.2%	44.5%	47.9%	48.0%	42.5%	39.5%	45.5%	49.2%	49.3%	44.3%	41.0%	46.9%
% Increase	-4.6%	21.6%	25.0%	42.3%	7.1%	24.1%	9.2%	-0.7%	-4.7%	12.8%	3.4%	0.9%	2.4%	9.0%	3.8%	3.3%
Selling Expense	251.2	75.3	80.9	65.8	60.0	282.0	80.2	80.5	64.9	62.0	287.5	81.0	82.1	65.1	63.1	291.3
As % Sales	24.7%	22.5%	21.3%	27.9%	34.4%	25.1%	21.9%	22.0%	29.5%	33.5%	25.3%	22.5%	22.5%	28.3%	34.1%	25.6%
% Increase	-13.3%	11.1%	6.0%	17.8%	17.1%	12.2%	6.5%	-0.6%	-1.4%	3.4%	2.0%	1.0%	2.1%	0.3%	1.8%	1.3%
G&A	79.7	21.6	24.2	19.4	23.9	89.1	22.5	22.8	25.0	24.5	94.8	22.7	22.6	23.9	25.0	94.2
As % Sales	7.8%	6.4%	6.4%	8.2%	13.7%	7.9%	6.1%	6.2%	11.4%	13.2%	8.3%	6.3%	6.2%	10.4%	13.5%	8.3%
% Increase	17.4%	6.6%	33.6%	-7.2%	16.8%	11.7%	4.3%	-5.8%	28.9%	2.4%	6.4%	0.9%	-0.7%	-4.3%	1.9%	-0.6%
R & D	26.8	8.0	7.9	7.9	8.2	32.0	7.9	7.5	8.0	8.0	31.5	8.0	7.6	8.0	7.5	31.1
As % Sales	2.6%	2.4%	2.1%	3.4%	4.7%	2.8%	2.2%	2.1%	3.6%	4.3%	2.8%	2.2%	2.1%	3.5%	4.1%	2.7%
% Increase	-0.8%	17.8%	27.7%	16.8%	16.7%	19.5%	-1.1%	-4.7%	0.9%	-2.1%	-1.7%	1.0%	0.8%	0.0%	-6.3%	-1.2%
Operating Expense	357.7	104.9	113.0	93.1	92.0	403.0	110.6	110.8	97.9	94.5	413.7	111.7	112.4	97.0	95.6	416.6
As % Sales	35.1%	31.3%	29.7%	39.5%	52.8%	35.8%	30.2%	30.3%	44.5%	51.1%	36.4%	31.0%	30.8%	42.2%	51.7%	36.5%
Operating Profit	45.6	55.9	64.1	5.0	(27.2)	97.7	65.0	65.0	(4.4)	(21.4)	104.1	65.4	67.6	4.9	(19.7)	118.2
Margin	4.5%	16.7%	16.9%	2.1%	-15.6%	8.7%	17.7%	17.8%	-2.0%	-11.6%	9.2%	18.2%	18.5%	2.1%	-10.7%	10.4%
% Increase	19.6%	49.4%	56.1%	134.2%	NA	114.1%	16.3%	1.4%	188.1%	NA	6.6%	0.7%	4.0%	NM	NA	13.5%
Interest Expense	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other Income	(2.1)	(1.3)	(1.9)	1.2	0.1	(1.9)	0.7	(2.6)	0.0	0.0	(1.9)	0.0	0.0	0.0	0.0	0.0
Pretax Profit	43.6	54.5	62.2	6.2	(27.1)	95.8	65.7	62.4	(4.4)	(21.4)	102.2	65.4	67.6	4.9	(19.7)	118.2
Margin	4.3%	16.3%	16.4%	2.6%	-15.6%	8.5%	17.9%	17.0%	-2.0%	-11.6%	9.0%	18.2%	18.5%	2.1%	-10.7%	10.4%
% Increase	22.8%	44.7%	56.3%	139.7%	NA	119.8%	20.4%	0.3%	170.8%	NA	6.8%	-0.3%	8.3%	NM	NA	15.6%
Taxes(benefit)	15.1	21.7	24.4	2.4	(11.9)	36.6	26.0	22.3	(1.7)	(8.2)	38.3	25.2	26.0	1.9	(7.6)	45.5
Rate	34.8%	39.8%	39.2%	39.1%	43.8%	38.2%	39.6%	35.7%	38.5%	38.5%	37.5%	38.5%	38.5%	38.5%	38.5%	38.5%
Net Income--Oper.	28.4	32.8	37.8	3.8	(15.2)	59.2	39.7	40.1	(2.7)	(13.2)	63.9	40.2	41.6	3.0	(12.1)	72.7
Margin	2.8%	9.8%	10.0%	1.6%	-8.7%	5.3%	10.8%	11.0%	-1.2%	-7.1%	5.6%	11.2%	11.4%	1.3%	-6.6%	6.4%
% Increase	8.2%	39.8%	57.8%	136.1%	NA	108.3%	20.8%	6.0%	NM	NA	7.9%	1.5%	3.6%	NM	NA	13.7%
EPS--Operations	0.41	0.48	0.55	0.06	(0.24)	0.88	0.61	0.63	(0.04)	(0.21)	1.00	0.63	0.65	0.05	(0.19)	1.14
% Increase	9.3%	43.5%	56.3%	135.7%	NA	111.5%	27.3%	14.9%	-175.6%	NA	13.6%	3.0%	3.7%	NM	NA	14.2%
Shares Out- Diluted	68.5	68.3	69.3	67.6	63.8	67.5	64.8	63.9	63.9	63.2	64.1	63.9	63.9	63.9	63.9	63.9

Source: Company reports and Morgan Joseph estimates

Required Disclosures



Price Target

Our price target is \$16.00.

Valuation Methodology

Our \$16 price target is derived from a 6.5x multiple to our FTM estimated EV/EBITDA.

Risk Factors

- Sales are susceptible to seasonality and unpredictable weather.
- Innovation and competition pose potential market share threats.
- The USGA regulates equipment guidelines and their impact on the sport.
- International business exposes Callaway to foreign currency risks.

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Rating	Investment Banking Services/Past 12 Mos.	
	Percent	Percent
BUY [B]	56.67	37.25
HOLD [H]	42.22	31.58
SELL [S]	1.11	0.00

Meaning of Ratings

A) Buy means reasonable outperformance relative to the market over 12-18 months.

- B) Hold means market-type risk adjusted performance; potential source of funds.
C) Sell means expected to underperform the market.

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