

October 15, 2008

Key Metrics

ELY - NYSE	\$11.87
Pricing Date	10/14/2008
Price Target	\$16.00
52-Week Range	\$18.20-\$9.78
Shares Outstanding (mm)	63.9
Market Capitalization (\$mm)	\$758.5
3-Mo Average Daily Volume	835,014
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	--	0.63E
2Q-Jun	0.55	--	0.63A	--	0.65E
3Q-Sep	0.06	(0.04)E	(0.09)E	--	0.05E
4Q-Dec	(0.24)	--	(0.21)E	--	(0.19)E
FY	0.88	1.00E	0.96E	--	1.14E
P/E	13.5x		12.4x		10.4x

Revenue(\$mm)

	2007A	Prior 2008E	Curr. 2008E	Prior 2009E	Curr. 2009E
1Q-Mar	334.6	--	366.5A	--	360.0E
2Q-Jun	380.0	--	366.0A	--	365.0E
3Q-Sep	235.5	220.0E	213.0E	--	230.0E
4Q-Dec	174.4	--	185.0E	--	185.0E
FY	1,124.6	1,137.5E	1,130.5E	--	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

Seasonally Slow 3Q Impacted By Global Weakness; Fundamentals Remain Strong

Investment Highlights:

- **3Q EPS projected at (\$0.08) to (\$0.10), roughly \$0.04 to \$0.06 below our estimate.** Callaway expects 3Q08 EPS, excluding a one-time, after-tax charge of \$0.04, to range between (\$0.08) to (\$0.10). The preliminary results are roughly \$0.04 to \$0.06 below our (\$0.04) projection. The Street consensus was \$0.00.
- **Challenging comps/global weakness reduces sales roughly 10%.** 3Q08 sales are estimated to be roughly \$213mm, \$7mm below our estimate and down \$23mm Y/Y. Outside of extremely challenging 3Q07 comparisons, which saw Y/Y sales up 22%, international/U.S. revenues came in lower than expected. Additionally impacting results, in our opinion, were key products on the back nine of a two year sales cycle.
- **Operating efficiencies improve yet gross margins take a hit.** Tightly managed operating expenses appear to be below expectations; however, reduced sales leverage and product mix could negatively impact gross margins as much as 200 bps.
- **Guidance reduced in-line with our FY expectations: Our FY EPS estimate lowered due to 3Q difference.** Updated management 2008 guidance is for between \$0.92 to \$1.02 per share. This falls in line with our previous estimate of \$1.00. While we are maintaining our estimates going forward, our 2008 EPS estimate has been reduced \$0.04 to reflect the potential shortfall in 3Q.
- **Cash flow expectation expands - inventories appear in good shape.** At quarter end, inventories, as a percent of TTM sales, are estimated at 19.7% and on track to end at roughly 20% of TTM sales by 2008 year end. This trend is below our expectations and would increase our 2008 FCF expectation by \$10mm to roughly \$60mm (estimated 8% FCF yield), which is expected to include roughly \$11mm in charges and a \$15mm one-time capital expenditure increase.
- **2009 product line apparently "stronger than 2007" which increased sales 10% Y/Y.** The 2007 product line expanded Y/Y sales 20% in 2007. While not completely released yet, management believes the 2009 product line is stronger than the record-setting 2007 line. If this proves true, further economic weakness should be somewhat mitigated with key new higher margined releases.
- **3Q actual results expected to be released October 30th, 2008; maintain our Buy rating.** Despite current non-peak seasonal sales weakness, we continue to believe Callaway is undervalued and well positioned for share growth. It maintains a solid balance sheet, strong free cash flow, geographic sales diversity, dominant market share, and an EV/EBITDA multiple well below its peer group.

EQUITY RESEARCH

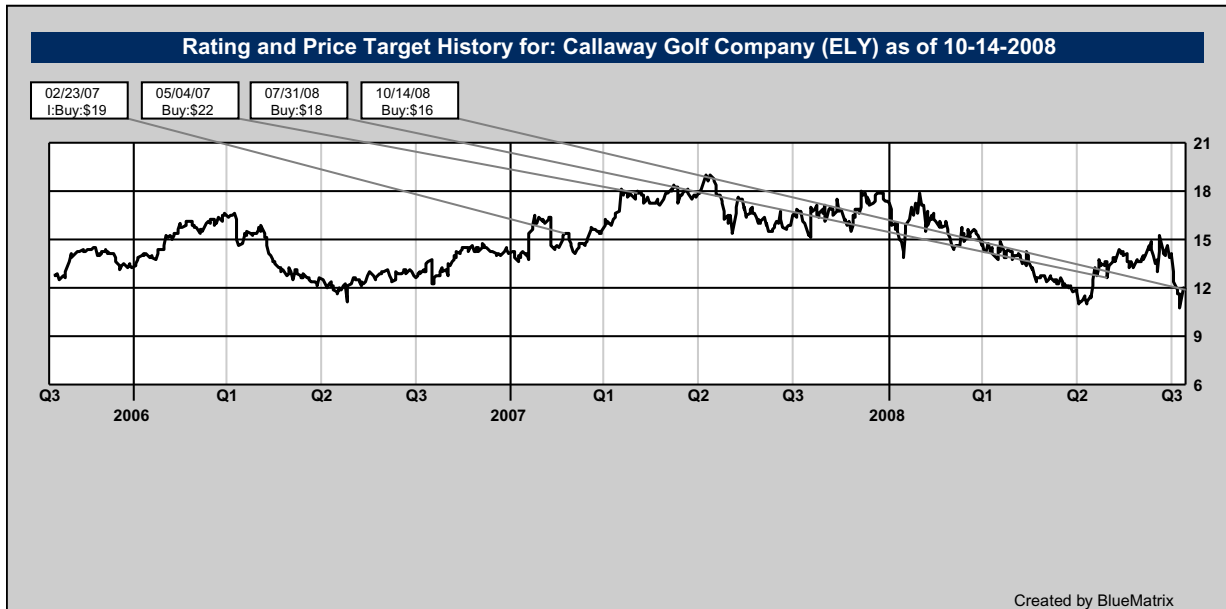
Callaway Golf (ELY)

(In Millions, Except Per Share Data)

	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	213.0	185.0	1130.5	360.0	365.0	230.0	185.0	1140.0
<i>% Increase</i>	2.0%	10.6%	11.2%	21.6%	-3.0%	10.5%	9.5%	-3.7%	-9.6%	6.1%	0.5%	-1.8%	-0.3%	8.0%	0.0%	0.8%
Cost of Goods Sold	614.6	173.9	202.9	137.4	109.6	623.9	190.9	190.3	128.9	111.9	622.0	182.9	185.1	128.1	109.2	605.2
<i>As % Sales</i>	60.4%	52.0%	53.4%	58.3%	62.8%	55.5%	52.1%	52.0%	60.5%	60.5%	55.0%	50.8%	50.7%	55.7%	59.0%	53.1%
<i>% Increase</i>	6.9%	2.1%	1.4%	10.1%	-8.2%	1.5%	9.8%	-6.3%	-6.2%	2.1%	-0.3%	-4.2%	-2.7%	-0.6%	-2.5%	-2.7%
Gross Profit	403.3	160.7	177.1	98.1	64.8	500.7	175.5	175.8	84.1	73.1	508.5	177.1	179.9	101.9	75.9	534.8
<i>Margin</i>	39.6%	48.0%	46.6%	41.7%	37.2%	44.5%	47.9%	48.0%	39.5%	39.5%	45.0%	49.2%	49.3%	44.3%	41.0%	46.9%
<i>% Increase</i>	-4.6%	21.6%	25.0%	42.3%	7.1%	24.1%	9.2%	-0.7%	-14.3%	12.8%	1.6%	0.9%	2.4%	21.1%	3.8%	5.2%
Selling Expense	251.2	75.3	80.9	65.8	60.0	282.0	80.2	80.5	62.0	62.0	284.6	81.0	82.1	65.1	63.1	291.3
<i>As % Sales</i>	24.7%	22.5%	21.3%	27.9%	34.4%	25.1%	21.9%	22.0%	29.1%	33.5%	25.2%	22.5%	22.5%	28.3%	34.1%	25.6%
<i>% Increase</i>	-13.3%	11.1%	6.0%	17.8%	17.1%	12.2%	6.5%	-0.6%	-5.8%	3.4%	0.9%	1.0%	2.1%	5.0%	1.8%	2.4%
G&A	79.7	21.6	24.2	19.4	23.9	89.1	22.5	22.8	23.0	24.5	92.8	22.7	22.6	23.9	25.0	94.2
<i>As % Sales</i>	7.8%	6.4%	6.4%	8.2%	13.7%	7.9%	6.1%	6.2%	10.8%	13.2%	8.2%	6.3%	6.2%	10.4%	13.5%	8.3%
<i>% Increase</i>	17.4%	6.6%	33.6%	-7.2%	16.8%	11.7%	4.3%	-5.8%	18.6%	2.4%	4.2%	0.9%	-0.7%	4.0%	1.9%	1.5%
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
<i>As % Sales</i>	2.6%	2.4%	2.1%	3.4%	4.7%	2.8%	2.2%	2.1%	3.8%	4.3%	2.8%	2.2%	2.1%	3.5%	4.1%	2.7%
<i>% Increase</i>	-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	93.0	94.5	408.8	111.7	112.4	97.0	95.6	416.6
<i>As % Sales</i>	35.1%	31.3%	29.7%	39.5%	52.8%	35.8%	30.2%	30.3%	43.7%	51.1%	36.2%	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	(8.9)	(21.4)	99.7	65.4	67.6	4.9	(19.7)	118.2
<i>Margin</i>	4.5%	16.7%	16.9%	2.1%	-15.6%	8.7%	17.7%	17.8%	-4.2%	-11.6%	8.8%	18.2%	18.5%	2.1%	-10.7%	10.4%
<i>% Increase</i>	19.6%	49.4%	56.1%	134.2%	NM	114.1%	16.3%	1.4%	NM	NM	2.0%	0.7%	4.0%	NM	NM	18.6%
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	(8.9)	(21.4)	97.8	65.4	67.6	4.9	(19.7)	118.2
<i>Margin</i>	4.3%	16.3%	16.4%	2.6%	-15.6%	8.5%	17.9%	17.0%	-4.2%	-11.6%	8.6%	18.2%	18.5%	2.1%	-10.7%	10.4%
<i>% Increase</i>	22.8%	44.7%	56.3%	139.7%	NM	119.8%	20.4%	0.3%	NM	NM	2.1%	-0.3%	8.3%	NM	NM	20.9%
Taxes(benefit)	15.1	21.7	24.4	2.4	(11.9)	36.6	26.0	22.3	(3.4)	(8.2)	36.6	25.2	26.0	1.9	(7.6)	45.5
<i>Rate</i>	34.8%	39.8%	39.2%	39.1%	43.8%	38.2%	39.6%	35.7%	38.5%	38.5%	37.4%	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	(5.5)	(13.2)	61.2	40.2	41.6	3.0	(12.1)	72.7
<i>Margin</i>	2.8%	9.8%	10.0%	1.6%	-8.7%	5.3%	10.8%	11.0%	-2.6%	-7.1%	5.4%	11.2%	11.4%	1.3%	-6.6%	6.4%
<i>% Increase</i>	8.2%	39.8%	57.8%	136.1%	NM	108.3%	20.8%	6.0%	NM	NM	3.3%	1.5%	3.6%	NM	NM	18.8%
EPS--Operations	0.41	0.48	0.55	0.06	(0.24)	0.88	0.61	0.63	(0.09)	(0.21)	0.96	0.63	0.65	0.05	(0.19)	1.14
<i>% Increase</i>	9.3%	43.5%	56.3%	135.7%	NM	111.5%	27.3%	14.9%	NM	NM	9.3%	3.0%	3.7%	NM	NM	18.7%
Shares Out. Diluted	68.5	68.3	69.3	67.6	63.8	67.5	64.8	63.9	62.5	63.2	63.8	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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