

December 18, 2008

**Key Metrics**

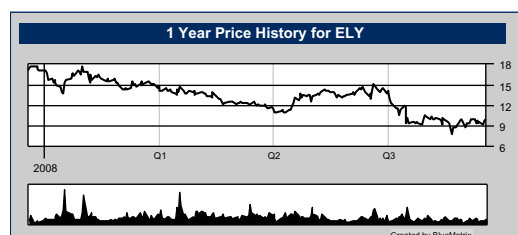
ELY - NYSE	\$9.98
Pricing Date	12/17/2008
Price Target	NA
52-Week Range	\$18.20-\$7.55
Shares Outstanding (mm)	64.6
Market Capitalization (\$mm)	\$644.7
3-Mo Average Daily Volume	736,562
Institutional Ownership	82%
Debt/Total Capital	6.3%
ROE	9.9%
Book Value/Share	\$9.54
Price/Book	1.0x
Dividend Yield	2.8%
LTM EBITDA Margin	11.65%

**EPS(\$)** FY: December

	2007A	Prior 2008E	Curr. 2008E	Prior 2009E	Curr. 2009E
1Q-Mar	0.48	--	0.61A	0.63E	0.55E
2Q-Jun	0.55	--	0.63A	0.65E	0.56E
3Q-Sep	0.06	--	(0.08)A	0.05E	(0.10)E
4Q-Dec	(0.24)	(0.21)E	(0.26)E	(0.19)E	(0.17)E
FY	0.88	0.96E	0.91E	1.14E	0.84E
P/E	11.3x		11.0x		11.9x

**Revenue(\$mm)**

	2007A	Prior 2008E	Curr. 2008E	Prior 2009E	Curr. 2009E
1Q-Mar	334.6	--	366.5A	360.0E	340.0E
2Q-Jun	380.0	--	366.0A	365.0E	340.0E
3Q-Sep	235.5	--	213.5A	230.0E	200.0E
4Q-Dec	174.4	185.0E	170.0E	185.0E	175.0E
FY	1,124.6	1,130.9E	1,115.9E	1,140.0E	1,055.0E



**Company Description:** ([www.callawaygolf.com](http://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: Hold

#### Economy Could Reduce Club Memberships/EPS: Downgrade To Hold

**Investment Highlights:**

- **Economic weakness could offset expected positives: downgrade to Hold.** The global economic slowdown continues to weigh on consumer sales. As a higher priced provider of golf equipment, Callaway may not be immune to such pressures. While ongoing cost cutting initiatives and expectations for a strong 2009 product line remain, potential foreign exchange headwinds, reductions in golf club memberships, and general economic weakness could provide too many barriers for Y/Y expand sales and EPS expansion in 2009.
- **Foreign currency translation benefited YTD 2008 sales by roughly \$21mm.** Foreign currency translation positively impacted Callaway's international sales by roughly \$21mm in Q1 and Q2 of 2008 with an estimated 60% to 70% (or \$0.12 to \$0.14 flowing to the bottom line). A repeat of those benefits may prove difficult in 2009.
- **Domestic club memberships could fall 10% to 15% in 2009.** According to the National Golf Foundation, two-thirds of existing members are highly likely to remain members of private golf clubs, with 20% on the fence, leaving 10% to 15% at risk of giving up their club membership. Money, or the lack thereof, appears to be the primary reason for potential membership losses.
- **Golf comps getting squeezed at retail.** During recent conference and quarterly calls, Dick's Sporting Goods (DKS-NYSE-\$14.66) cited difficulties within the golf business. Comparable store sales for golfing equipment were down roughly 7% with expectations for continued weakness in Q4 and potentially into 2009.
- **Lowering estimates to reflect uncertain environment and limited foreign-exchange benefit.** With limited visibility, potentially lower rounds played, and foreign-exchange headwinds, we are reducing our FY09 sales estimate by \$85mm to \$1.1bn and EPS estimate by \$0.30 to \$0.84. Ongoing cost cutting initiatives and potentially lower sales/marketing spend could keep margins relatively flat to slightly down Y/Y; however, projected sales declines should offset those benefits.
- **Strong balance sheet and industry strength bode well long-term, near-term not so clear, downgrade to Hold.** Callaway's strong balance sheet (\$51mm in cash and no LT debt), positive free cash flow and industry strength have, in our opinion, the company well positioned longer term; however, an uncertain economic environment and the company's exposure as a high-end golf supplier could put near-term EPS growth at risk. Currently trading at a 4.5x TTM EV/EBITDA multiple, our reduced estimates reflect a similar multiple to our FY09 EBITDA estimate of \$125mm.

EQUITY RESEARCH

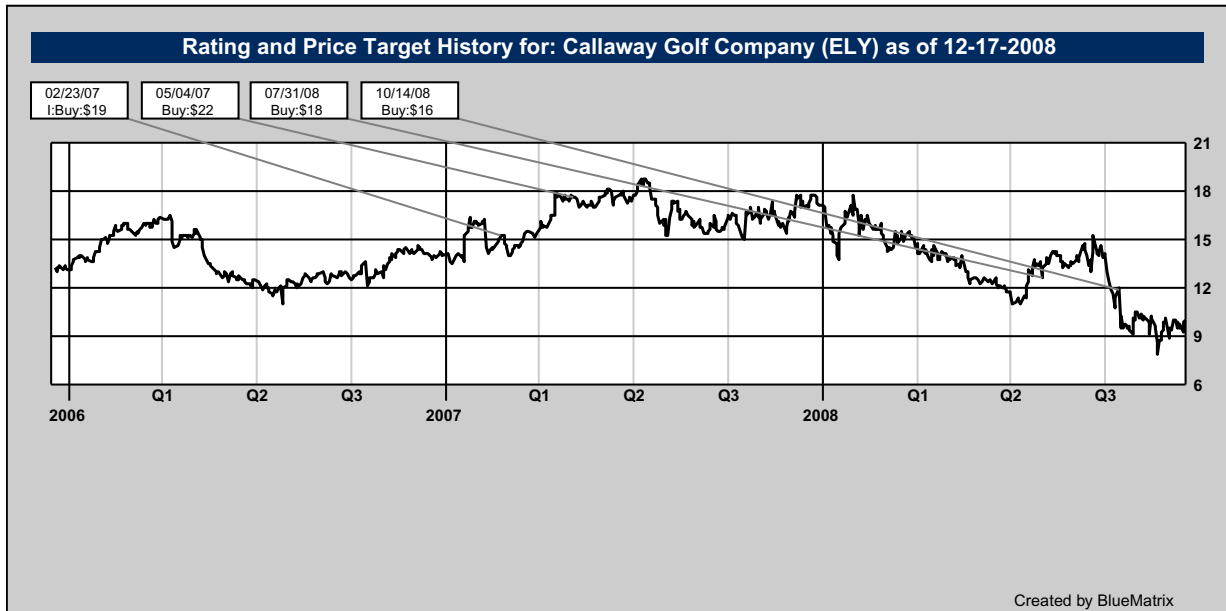
## Callaway Golf (ELY)

(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	Q3 Sep-08	Q4E Dec-08	FYE 2008	Q1E Mar-09	Q2E Jun-09	Q3E Sep-09	Q4E Dec-09	FYE 2009
<b>Sales</b>	<b>1017.9</b>	<b>334.6</b>	<b>380.0</b>	<b>235.5</b>	<b>174.4</b>	<b>1124.6</b>	<b>366.5</b>	<b>366.0</b>	<b>213.5</b>	<b>170.0</b>	<b>1115.9</b>	<b>340.0</b>	<b>340.0</b>	<b>200.0</b>	<b>175.0</b>	<b>1055.0</b>
% Increase	2.0%	10.6%	11.2%	21.6%	-3.0%	10.5%	9.5%	-3.7%	-9.4%	-2.5%	-0.8%	-7.2%	-7.1%	-6.3%	2.9%	-5.5%
Cost of Goods Sold	614.6	173.9	202.9	137.4	109.6	623.9	190.9	190.3	129.7	106.3	617.2	176.1	175.8	120.6	106.6	579.1
As % Sales	60.4%	52.0%	53.4%	58.3%	62.8%	55.5%	52.1%	52.0%	60.8%	62.5%	55.3%	51.8%	51.7%	60.3%	60.9%	54.9%
% Increase	6.9%	2.1%	1.4%	10.1%	-8.2%	1.5%	9.8%	-6.3%	-5.6%	-3.0%	-1.1%	-7.8%	-7.6%	-7.0%	0.3%	-6.2%
<b>Gross Profit</b>	<b>403.3</b>	<b>160.7</b>	<b>177.1</b>	<b>98.1</b>	<b>64.8</b>	<b>500.7</b>	<b>175.5</b>	<b>175.8</b>	<b>83.8</b>	<b>63.7</b>	<b>498.8</b>	<b>163.9</b>	<b>164.2</b>	<b>79.4</b>	<b>68.4</b>	<b>475.9</b>
Margin	39.6%	48.0%	46.6%	41.7%	37.2%	44.5%	47.9%	48.0%	39.2%	37.5%	44.7%	48.2%	48.3%	39.7%	39.1%	45.1%
% Increase	-4.6%	21.6%	25.0%	42.3%	7.1%	24.1%	9.2%	-0.7%	-14.6%	-1.7%	-0.4%	-6.6%	-6.6%	-5.2%	7.4%	-4.6%
Selling Expense	251.2	75.3	80.9	65.8	60.0	282.0	80.2	80.5	65.7	60.0	286.3	78.0	78.0	63.0	57.0	276.0
As % Sales	24.7%	22.5%	21.3%	27.9%	34.4%	25.1%	21.9%	22.0%	30.8%	35.3%	25.7%	22.9%	22.9%	31.5%	32.6%	26.2%
% Increase	-13.3%	11.1%	6.0%	17.8%	17.1%	12.2%	6.5%	-0.6%	-0.2%	0.1%	1.5%	-2.7%	-3.1%	-4.1%	-5.0%	-3.6%
G&A	79.7	21.6	24.2	19.4	23.9	89.1	22.5	22.8	20.2	23.0	88.5	22.0	22.0	20.0	22.0	86.0
As % Sales	7.8%	6.4%	6.4%	8.2%	13.7%	7.9%	6.1%	6.2%	9.5%	13.5%	7.9%	6.5%	6.5%	10.0%	12.6%	8.2%
% Increase	17.4%	6.6%	33.6%	-7.2%	16.8%	11.7%	4.3%	-5.8%	4.2%	-3.9%	-0.7%	-2.2%	-3.5%	-1.0%	-4.3%	-2.8%
R & D	26.8	8.0	7.9	7.9	8.2	32.0	7.9	7.5	6.7	7.5	29.6	7.0	7.0	7.0	7.0	28.0
As % Sales	2.6%	2.4%	2.1%	3.4%	4.7%	2.8%	2.2%	2.1%	3.1%	4.4%	2.7%	2.1%	2.1%	3.5%	4.0%	2.7%
% Increase	-0.8%	17.8%	27.7%	16.8%	16.7%	19.5%	-1.1%	-4.7%	-16.1%	-8.2%	-7.5%	-11.7%	-7.1%	5.3%	-6.7%	-5.4%
Operating Expense	357.7	104.9	113.0	93.1	92.0	403.0	110.6	110.8	92.6	90.5	404.4	107.0	107.0	90.0	86.0	390.0
As % Sales	35.1%	31.3%	29.7%	39.5%	52.8%	35.8%	30.2%	30.3%	43.4%	53.2%	36.2%	31.5%	31.5%	45.0%	49.1%	37.0%
<b>Operating Profit</b>	<b>45.6</b>	<b>55.9</b>	<b>64.1</b>	<b>5.0</b>	<b>(27.2)</b>	<b>97.7</b>	<b>65.0</b>	<b>65.0</b>	<b>(8.8)</b>	<b>(26.8)</b>	<b>94.4</b>	<b>56.9</b>	<b>57.2</b>	<b>(10.6)</b>	<b>(17.6)</b>	<b>85.9</b>
Margin	4.5%	16.7%	16.9%	2.1%	-15.6%	8.7%	17.7%	17.8%	-4.1%	-15.8%	8.5%	16.7%	16.8%	-5.3%	-10.0%	8.1%
% Increase	19.6%	49.4%	56.1%	134.2%	NM	114.1%	16.3%	1.4%	NM	NM	-3.4%	-12.4%	-11.9%	NM	NM	-8.9%
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)	(1.7)	0.0	(3.6)	0.0	0.0	0.0	0.0	0.0
<b>Pretax Profit</b>	<b>43.6</b>	<b>54.5</b>	<b>62.2</b>	<b>6.2</b>	<b>(27.1)</b>	<b>95.8</b>	<b>65.7</b>	<b>62.4</b>	<b>(10.5)</b>	<b>(26.8)</b>	<b>90.8</b>	<b>56.9</b>	<b>57.2</b>	<b>(10.6)</b>	<b>(17.6)</b>	<b>85.9</b>
Margin	4.3%	16.3%	16.4%	2.6%	-15.6%	8.5%	17.9%	17.0%	-4.9%	-15.8%	8.1%	16.7%	16.8%	-5.3%	-10.0%	8.1%
% Increase	22.8%	44.7%	56.3%	139.7%	NM	119.8%	20.4%	0.3%	NM	NM	-5.2%	-13.4%	-8.3%	NM	NM	-5.3%
Taxes(benefit)	15.1	21.7	24.4	2.4	(11.9)	36.6	26.0	22.3	(5.3)	(10.3)	32.7	21.9	22.0	(4.1)	(6.8)	33.1
Rate	34.8%	39.8%	39.2%	39.1%	43.8%	38.2%	39.6%	35.7%	50.6%	38.5%	36.0%	38.5%	38.5%	38.5%	38.5%	38.5%
<b>Net Income--Oper.</b>	<b>28.4</b>	<b>32.8</b>	<b>37.8</b>	<b>3.8</b>	<b>(15.2)</b>	<b>59.2</b>	<b>39.7</b>	<b>40.1</b>	<b>(5.2)</b>	<b>(16.5)</b>	<b>58.1</b>	<b>35.0</b>	<b>35.2</b>	<b>(6.5)</b>	<b>(10.8)</b>	<b>52.8</b>
Margin	2.8%	9.8%	10.0%	1.6%	-8.7%	5.3%	10.8%	11.0%	-2.4%	-9.7%	5.2%	10.3%	10.4%	-3.3%	-6.2%	5.0%
% Increase	8.2%	39.8%	57.8%	136.1%	NM	108.3%	20.8%	6.0%	NM	NM	-1.8%	-11.8%	-12.3%	NM	NM	-9.1%
<b>EPS--Operations</b>	<b>0.41</b>	<b>0.48</b>	<b>0.55</b>	<b>0.06</b>	<b>(0.24)</b>	<b>0.88</b>	<b>0.61</b>	<b>0.63</b>	<b>(0.08)</b>	<b>(0.26)</b>	<b>0.91</b>	<b>0.55</b>	<b>0.56</b>	<b>(0.10)</b>	<b>(0.17)</b>	<b>0.84</b>
% Increase	9.3%	43.5%	56.3%	135.7%	NM	111.5%	27.3%	14.9%	NM	NM	3.8%	-9.5%	-11.2%	NM	NM	-8.2%
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	63.2	63.2	63.2	63.2	63.2

Source: Company reports and Morgan Joseph estimates

**Required Disclosures**



I, Jeffrey Blaeser, the author of this research report, certify that the views expressed in this report accurately reflect my personal views about the subject securities and issuers, and no part of my compensation was, is, or will be directly or indirectly tied to the specific recommendations or views contained in this research report.

Research analyst compensation is dependent, in part, upon investment banking revenues received by Morgan Joseph & Co. Inc.

Morgan Joseph & Co. Inc. intends to seek or expects to receive compensation for investment banking services from the subject company within the next three months.

Rating	Investment Banking Services/Past 12 Mos.	
	Percent	Percent
BUY [B]	54.65	36.17
HOLD [H]	43.02	29.73
SELL [S]	2.33	0.00

- Meaning of Ratings
- A) Buy means reasonable outperformance relative to the market (Russell 2000) over 12-18 months.
  - B) Hold means market-type (Russell 2000) risk adjusted performance; potential source of funds.
  - C) Sell means expected to underperform the market (Russell 2000) over 12-18 months.

**Other Disclosures**

The information contained herein is based upon sources believed to be reliable but is not guaranteed by us and is not considered to be all inclusive. It is not to be construed as an offer or the solicitation of an offer to sell or buy the securities mentioned herein. Morgan Joseph & Co. Inc., its affiliates, shareholders, officers, staff, and/or members of their families, may have a position in the securities mentioned herein, and, before or after your receipt of this report, may make or recommend purchases and/or sales for their own accounts or for the accounts of other customers of the Firm from time to time in the open market or otherwise. Opinions expressed are our present opinions only and are subject to change without notice. Morgan Joseph & Co. Inc. is under no obligation to provide updates to the opinions or information provided herein. Additional information is available upon request.

**Morgan Joseph & Co. Inc.**

600 Fifth Avenue, 19th Fl

New York, NY 10020

Tel. 212.218.3700

Fax. 212.218.3789

**Sales and Trading**

**New York**

Tel. 212.218.3767

Fax. 212.218.3705

**Pittsford**

Tel. 877.237.6542

Fax. 585.899.6029