

Strategic Report for The Callaway Golf Company



Harkness Consulting
Innovation through Collaboration

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Table of Contents

Executive Summary	3
Company Background	5
Competitive Analysis.....	7
Internal Rivalry.....	8
Entry	12
Substitutes & Complements	13
Buyer & Supplier Power	14
SWOT Analysis	15
Strengths	15
Weaknesses	15
Opportunities	16
Threats.....	16
Financial Analysis	16
Strategic Issues & Recommendations.....	21
References.....	25

Executive Summary

Harkness Consulting has been asked by Callaway Golf to assess its strategic market position and to make recommendations for improving the company's performance. There is much to like about the company, but there are also reasons for serious concern about its prospects.

Callaway enjoys a reputation as one of the world's leading manufacturers of high-end golf clubs and golf accessories. It places great emphasis on developing cutting edge technology. For example, Callaway was the first to mass-produce titanium drivers and composite drivers. This strategy has helped the company establish a strong product portfolio, including especially Big Bertha Drivers, X-series Irons, and White Hot putters. Callaway competes not only on the quality of products, but also on emotion and image. Golf is an industry characterized by strategic endorsements combined with appealing new technology to entice a fickle consumer base. Callaway's current brands include Callaway, Odyssey, Top Flite, and Ben Hogan. Despite these strengths, Callaway faces some challenges.

The golf industry has been shrinking over the past few years; golf is decreasing in popularityⁱ. After a peak of golfers and rounds, a downward trend has occurredⁱⁱ. In 2007 17 million fewer rounds were played than in 2000ⁱⁱⁱ

Unlike the success of Callaway's purchase of Odyssey, its 2003 acquisitions of the Ben Hogan and Top Flite brand have been disappointments to date. The Ben Hogan brand has lost much of the respect that it once commanded as a leader in the wedge field, and their golf balls have not done well. Top Flite has lost the market share that it once had in the golf ball industry, but has seen some recent success with the introduction of the D2 series golf balls. Along with the failure of many of its acquisitions projects some of the Callaway introductions have also been abysmal failures.

Callaway's marketing strategy makes heavy use of endorsements by professional golfers. Unfortunately, the superstar of golf, Tiger Woods, is in a strong deal with Nike, and this has left Callaway with a second tier of golfers like Phil Mickelson and Ernie Els. While Mickelson and Els can influence a different market segment than Tiger Woods, no one can create the television coverage and general hysteria of Tiger Woods. Callaway has been well served by endorsements from Annika Sorenstam and Arnold Palmer, which have helped them capture the female and senior market. However, Sorenstam is nearing the end of her career and today Palmer is just a figurehead. TaylorMade has the strongest PGA tour following; more of its players use TaylorMade drivers than all other brands combined. Titleist is the number one ball in all of golf.

Harkness Consulting proposes a major shift in strategy to boost Callaway Golf's revenue growth and profits. We recommend that Callaway use its Top Flite brand to establish a lower cost, economy line of clubs. These would be rebranded models of past years' Callaway technology. This approach could be a large revenue driver. Golf club models that require millions in research & development sometimes have only a shelf life of two to three years^{iv}. This technology is still completely satisfactory for many golfers for as many as five to seven years after it is initially released. Harkness believes players would prefer to purchase a brand new Top Flite club rather than three-year-old unused Callaways or a used Callaway model for the same price.

Top Flite is an established brand. Using it for an economy line of clubs would give it instant recognition without taking away from the image of Callaway as a premium line. Presently Callaway attempts to serve this lower price market keeping in its product line earlier editions of Callaway clubs. It also sells Callaway trade-ins as "previously owned" clubs. However, its distribution channels for this approach are quite limited and they are competing against the 800-lb gorilla, Ebay.

By using Top Flite as a platform for lower priced clubs our client would be able to market them to large big box retailers such as Wal-Mart and Target. Almost certainly Top Flite clubs would eagerly be offered prominent shelf space in big box specialty retailers such as The Sports Authority, Oshman's Sporting Goods, Big 5 Sporting Goods, and Dick's Sporting Goods. A move into these kinds of stores would attract a new lower income market segment of golfers and would mean that Callaway produced clubs would be available seamlessly to multiple income-level segments. The use of the Top Flite branded clubs would connect with the demographics those companies appeal to, while protecting the Callaway's brand reputation as a producer of premium golf.

Company Background

Callaway Golf was founded in 1982 by Ely Callaway, an entrepreneur with a personal interest in the game of golf. Before entering the golf industry, Callaway had a successful career as president of a textile company. He also owned a California vineyard and winery, which he sold in 1981. Callaway reinvested the following year in Hickory Stick USA, a company specializing in golf wedges and putters with a steel-core and hickory shaft. With half of the company holdings, Callaway became President and CEO in 1983, and renamed the company to Callaway Hickory Stick USA. He became the full owner of Callaway Hickory Stick USA in 1984 for an additional \$400,000 investment^v. In 1985, the company moved from Cathedral City, California to its current location in Carlsbad, California. Ely Callaway's company adopted its current name, Callaway Golf Company, in 1988.

Callaway Golf has maintained a reputation as a leading innovator in the golf industry over its 26-year history. The company moved into more technologically based designs in the late 1980s. Callaway hired former billiard cue designer Richard C. Helmstetter as their chief club designer in 1986. The same year, Callaway Golf became the first among its competitors to use computer-controlled milling machines to manufacture putters, a process which guaranteed uniform flatness of each putter face. In 1988, Callaway Golf introduced its Core S2H2 design for Irons, which led the field in club design. Company sales climbed from \$4.8 million in 1988 to \$10.4

million in 1989^{vi}. The S2H2 Drivers became the most prominent driver on the Senior PGA Tour within a year. In 1990, Callaway Golf began producing a women's line of S2H2 clubs. Callaway released the Big Bertha Driver in 1991, a pivotal new line for the company and the industry as a whole. The club's innovative design made it the first wide body, stainless steel driver. By the following year, the Big Bertha was the most prominent driver on the Senior Tour, LPGA Tour, and Hogan Tour. Sales in 1992 hit \$133 million, a figure more than twice the \$54.5 million in sales during the previous year.

Callaway Golf went public in 1992 under the ticker ELY on the New York Stock Exchange. The stock opened at \$20 a share, and closed its opening day at \$36 per share. Callaway continued its streak of club design advancements with the Big Bertha Warbird Stainless Steel Woods and Irons in 1994. By 1995, Callaway Golf was the number one manufacturer of woods and irons, with sales reaching \$557M. Callaway could boast that by 1995, their driver was number one on the PGA, Senior PGA, LPGA, Nike, and European PGA tours. Golf professionals representing Callaway enhanced the brand image with a series of wins. Prominent tour players associated with the Callaway name include Johnny Miller, Annika Sorenstam, Jim Colbert, David Leadbetter, Arnold Palmer, Charles Howell III, Bruce Fleisher, and Phil Mickelson.

One of Callaway Golf's greatest developments came in 1995 with the Great Big Bertha Titanium Driver, a club that was significantly larger and lighter than its predecessors. They continued this line with Fairway Woods the following year, and began manufacturing Tungsten Titanium Irons in 1997. Roger Cleveland became the company's chief club designer in 1996, and Callaway began to design and manufacture golf balls the same year with engineers recruited from Boeing and Du Pont. They debuted their Rule 35 Golf Balls in 2000, the product of a \$170 million investment. The Rule 35 had disappointingly low sales, largely because of competition from a new Nike ball released the same year. Callaway's subsequent line of HX balls in 2002 replaced the traditional dimple pattern on golf balls with a more aerodynamically efficient hexagonal pattern. They were the first manufacturer of golf products to receive over 100 US patents in one year. In 2003, Callaway had been the number one brand in woods, irons, and

putters for seven consecutive years. This period, however, was not completely without setbacks. In 2001, Callaway underwent a dispute with the U.S. Golf Association over the “hot face” design of their new ERC drivers. The USGA succeeded in limiting the level of COR, or spring-like, technology in clubs used in tour competitions. This regulation hindered Callaway’s growth as a technological leader in the industry.

Ely Callaway stepped down as President and CEO in 1996, and Donald H. Dye took over. Callaway maintained a promotional role in the company, and returned as President and CEO in 1998. Callaway retired in 2001, shortly before his death at the age of 82. Ron Drapeau became President and CEO following Callaway. Drapeau has maintained the Callaway Golf reputation for creating innovative designs for a range of golf ability levels. Callaway Golf has grown through its own innovations and its acquisitions, including Odyssey Sports, Inc. in 1997, and Top Flite and Ben Hogan brands in 2003^{vii}. Today, Callaway sells golf clubs, balls, and accessories under the Callaway, Odyssey, Top Flite, and Ben Hogan names.

Competitive Analysis

Callaway Golf (ELY) operates in the Sporting and Athletics Goods Manufacturing Industry Segment (NAICS Code 339920). ELY’s operations are split into five primary segments: drivers, irons, putters, golf balls and accessories.

Products in the drivers category include drivers, fairway woods and hybrids sold under the Callaway Golf, Ben Hogan and Top-Flite brand names. Callaway is currently #2 in this segment, only behind TaylorMade (Adidas), with a 19.5% share domestically and a 21.0% share in the U.K.

Products in the irons category include irons and wedges sold under the Callaway Golf, Ben Hogan and Top-Flite brand names. Callaway holds the number one position in the iron market, with a 25.6% share domestically and a 24.6% share in the U.K.^{viii}.

Products in the putters category include putters sold under the Odyssey, Callaway Golf, Ben Hogan and Top-Flite brand names. Callaway is currently the #1 vendor in the putter market, with a 38.5% share domestically and a 37.4% share in the UK.

Products in the golf ball category include balls sold under the Callaway Golf and Top-Flite brand names. Callaway holds the #2 position in the golf ball market, with a 12.2% share domestically and a 13.5% share in the U.K.

Products in the accessories category include golf bags, footwear, gloves, headwear, towels, umbrellas and other accessories, as well as the sale of pre-owned products through Callaway Golf Interactive. Revenues in this segment are also derived from royalties from the Company's trademarks.

Internal Rivalry

The participation of “core golfers” and rounds of golf played yearly drive the golf equipment sales. Core golfers are adult golfers who play eight or more rounds of golf per year and account for 87% of total domestic participation and 87% of total golf expenditures. The majority of core golfers are located in the Atlantic (35% of core golfers) and Northeastern (24% of golfers) regions of the United States, with a strong presence of core golfers on the Pacific Coast (13% of core golfers). On average, core golfers have an annual household income of \$86,000. Another driver of golf industry growth is the number of 18-hole rounds of golf played within a year. With respect to core golfers, 47% of golfers played 8-24 rounds of golf in 2006, in contrast to only 2% of golfers who played more than 200 rounds during that same period. Individuals 70+ years of age playing on average 48 rounds of golf.

The golf equipment industry is quite mature and saturated in the United States, and the largest impact on industry growth could be expected from a demographic shift in the core participant group, namely, the retirement of baby boomers, which is starting to happen now. As this generation gets older, they will form a large fraction of the core golfers group, and provide a strong customer base for Callaway and its competitors.

There is also a growth opportunity in the international market. As people in the developing countries accumulate wealth and are able to devote more time to leisure, golf becomes more popular. China Golf Association projects the total number of golfers to reach 3.7 million by 2010, and if the penetration rate of golfers in China reaches at least one quarter of that in Japan, the number would rise to 27 million. One threat in this market is the presence of counterfeiters, who compete for customers that care more about the price as opposed to the quality and performance of the equipment. Ostensibly, this is a threat that Callaway can mitigate by offering its older models at steep discounts, such that they can successfully compete for that market. However, it should not present a real threat to the high-end customers that Callaway caters to. So far, Callaway was able to sustain leadership internationally; building principal market shares in most of its segments in Europe and Asia.

The golf equipment industry lies on a spectrum of low-end to high-end manufacturers. The low-end manufacturers include Spalding, MacGregor, and Dunlop that mainly sell equipment for amateur players. The high-end manufacturers include Callaway, TaylorMade, Ping, Nike, and Titleist. These manufacturers sell professional equipment, usually at specialty golf-shops. Catering towards more seasoned players, who mostly fall into the “core” participant group, these companies are able to extract higher margins on their sales. One could argue that Callaway’s customer is less concerned with price, and more so with the quality of his purchase, and perhaps, the image/sense of prestige that comes along with the purchase. Therefore, the strongest decision-drivers in this segment are quality of the products and their marketing. Companies compete on the quality/performance as well as overall image of their equipment by investing heavily in research and development (R&D) and marketing campaigns. Nike, for instance, offered a \$100 mm 5-year endorsement to Tiger Woods and Callaway has spent \$32 mm on R&D in 2007 (one-third of their operating income)^{ix}. In fact, this industry has become so technologically driven that most “new” golf clubs do not stay on the shelves for longer than two years, at which point the companies are forced to match their competitors’ “new, improved models” by offering their own new equipment. Industry rivals have a tendency to copy each

others' innovation: Ping Golf pioneered the idea of custom fitting an iron to individual golfers, but other high-end manufacturers were quick to adopt that service.

Such intense rivalry is justified by the fact that the golf equipment industry is not expected to grow dramatically. Therefore, for the main companies to continue to grow, they have to compete for market share more so than players of a fast-growing industry. However, price wars are unlikely in the high-end segment of the industry, since the consumers do not exhibit strong price sensitivity and are more concerned with qualitative factors such as performance, brand name, and customer service.

In the market for high-end golf clubs, Callaway is one of the clear leaders, however, it derives almost 36% of its revenues (2007) from sales of golf balls and accessories^x. Callaway bought Top Flite in 2003 to beef up its golf ball segment, and has finally turned its golf ball operations profitable. A combination of premium quality Callaway and lower-end Top Flite golf balls should provide a good revenue mix in this segment. We believe that this segment is the least consolidated and Callaway has a lot of room to capture market share if they focus on improving quality and image of the product and successfully integrate manufacturing and R&D force of Top Flite.

The accessories segment is hard to break down because Callaway does not itemize the revenues by each type of accessory (bags, footwear, apparel, etc). However, it certainly is not the leader in the footwear market. A specialized golf footwear producer FootJoy enjoys almost a 50% market share according to Golfweek.com, with Ecco, Nike, and Adidas trailing behind.

Below is a list of the top competitors to Callaway broken down by what they produce. It is worthwhile to know that most start ups that succeed only engage in putters and wedges because they are art mixed with science, rather than the pure engineering that goes into drivers, woods, & irons:

	<i>Drivers</i>	<i>Fairways & Hybrids</i>	<i>Iron Sets</i>	<i>Putters</i>	<i>Wedges</i>
Adams	X	X	X	O	X
Bettinardi	O	O	O	X	X
Bridgestone Precept	X	X	X	X	X
Callaway	X	X	X	X	X
Carbite	O	O	O	X	X
Cleveland	X	X	X	X	X
Cobra	X	X	X	X	X
Founders Club	X	X	X	X	X
Guerin Rife	O	O	O	X	O
Heavy Putter	O	O	O	X	O
Henry Griffitts	O	O	O	O	X
Hog	O	O	O	X	O
Kasco	O	O	O	X	O
Lynx	X	X	X	X	X
MacGregor	X	X	X	X	X
Maxfli Dunlop	X	X	X	X	X
Mizuno	X	X	X	X	X
Nancy Lopez(W Only)	X	X	X	X	X
Never Compromise	O	O	O	X	O
Nickent	X	X	X	X	X
Nicklaus	X	X	X	X	X
Nike	X	X	X	X	X
Orlimar	X	X	X	O	X
Ping	X	X	X	X	X
Pixl	O	O	O	X	O
PowerBilt	X	X	X	X	X
Ram	X	X	X	X	X
Ray Cook	O	O	O	X	X
Reid Lackhart	O	O	O	O	X
See More	O	O	O	X	O
Snake Eyes	O	O	O	X	X
Sonartec	O	X	O	O	O
Square Two(W Only)	X	X	X	X	X
Srixon	X	X	X	X	X
STX	O	O	O	X	O
TaylorMade	X	X	X	X	X
Tear Drop	O	O	O	X	O
Titleist	X	X	X	X	X
Tommy Armour	X	X	X	X	X
Tour Edge	X	X	X	X	X
Walter Hagen	X	X	X	X	X
Wilson	X	X	X	X	X
Yes!	O	O	O	X	O
Yonex	X	X	X	X	X
Zevo	O	O	O	O	X
Totals	<u>27</u>	<u>28</u>	<u>27</u>	<u>39</u>	<u>34</u>

Note: Some of these companies are subsidiaries of others; this was taken into account when tallying totals. X = Company produces product, O = Company does not produce product.^{xi}

Entry

The threat of new entrants into the market is moderate. A small player entering the golf equipment market would not be competing for the same type of customers as Callaway, simply because it would not have the technologically advanced equipment and the brand name that Callaway has to offer. Since the high-tech materials, such as carbon fiber or super-light metal alloys, used in production of high-end golf clubs are available from only a few manufacturers, a small company would have a difficult time accessing these. And given that Callaway's inventories and property, plant and equipment amount to almost \$380 mm^{xii}, and considering the importance of R&D and marketing, the expenses that an entrant would have to incur in order to compete on the same level with a company of Callaway's scale, stand at half a billion dollars. Sporting goods companies that have such capacities and potential interest to diversify into golf are the most viable entrants, but Adidas and Nike are already in the market, and there seem to be no large sporting goods producers that are not in the market already.

However, the lack of any real barriers to entry in this market makes it possible for any custom golf club maker to start-up their own company. Although we do not believe that these companies pose a large threat to Callaway, it stands to be noted that every small entrant takes away some level of market share from Callaway, or the other larger firms. One example of this is the putter market, where less start-up costs are required. Yes! Putters have done a phenomenal job at creating a putter that lets the ball start rolling sooner, rather than hopping or skidding like most putters on the market. Although success stories like this are rare, Yes! has definitely taken away market share from Odyssey by offering a \$300 completely customized product.

Substitutes & Complements

Substitution is a strong competitive factor within the high-end segment for golf clubs, and brand loyalty is not a strong defense against competition above a certain price threshold. A “core” golf player would probably view Callaway and TaylorMade drivers as very close substitutes.

A different kind of a threat may come from the older models of golf clubs, which can be regarded as close substitutes for the newer ones by a lot of core and non-core players. Callaway is mitigating this threat through its Callaway Pre-Owned & Outlet online store, where older models are sold at high discounts.

In addition to that, however, there exist external threats to the golf industry. The last spike in golf popularity came with Tiger Woods, and if another strong personality appears in a “country club” sport, such as tennis, we may see a shift in the number of players away from golf into the new popular sport. And just as Tiger’s appearance affected primarily the younger generations of golfers, this threat would probably also affect men and women between 18 and 35, rather than the older golf players.

Also, by being a leisure activity, golf has many substitutes in the same segment, and not necessarily sport-related activities. Vacations, ship cruises, and any other outdoor leisure activity may be regarded as a substitute to golf.

The range of complements can be vast, but the most obvious ones are golf balls and golf accessories: footwear, apparel, gloves, etc. Callaway has conveniently positioned itself to offer its customers the full line of golf-related items, starting with drivers and ending with hats, which allows Callaway to extract additional suppliers’ surplus on these complementary transactions. However, golf accessories do not seem to be Callaway’s strength: their market position in some of the accessories markets is thwarted by sporting goods conglomerates or specialized producers of golf apparel, footwear, etc. (Nike, Adidas, FootJoy, etc)

Buyer & Supplier Power

High-end golf equipment manufacturers sell through on-course golf-shops, off-course golf-shops, and online venues. Since most of these distributors are not large, and usually do not account for more than 3% of a manufacturer's sales, they have rather low buyer power. This would have been very different, had the high-end manufacturers chosen to use the same channels as low-end ones: large department stores a la Walmart that would exert much greater power over producers by increasing the size of the orders.

End users, or "core" golfers in this case, have some buyer power because they usually have the information about the features of the products they're buying. Many golf magazines feature comparisons of various golf clubs and their performance characteristics, and this information is easy to find, making golf equipment, essentially, a "search good". Also, end users have relatively low switching costs between rival products, adding to their power.

On the supplier side, the essential aspect is the labor force employed in R&D and selling and marketing campaigns that a golf equipment manufacturer undertakes. The market for star golfers is a very limited one, which leaves very little power to golf equipment manufacturers. There are little outsourcing opportunities in design because almost all pieces of an iron are technologically advanced (aside from the grips that can be outsourced rather easily), and this gives more power to the labor suppliers in R&D.

Manufacturing of the golf clubs is usually subcontracted to casting houses, which creates a symbiotic relationship between the manufacturing facility and the ultimate golf club producer. Companies are very particular about the manufacturing quality level, and once they find a subcontractor that fits their standards, they tend to continue a working relationship with them, because finding a new high-quality manufacturer can be costly. On the other hand, the subcontractor's production line is very specialized towards its client's needs, which makes it hard and risky for them to switch to a different customer.

SWOT Analysis

Strengths

- Relatively large and diversified golf business (Drivers, Woods, Irons, Putters, Balls, Apparel)
- Strong core branding (Odyssey & Callaway)
- Ideal product placement in golf stores/pro shops
- Wide brand recognition of quality & integrity
- Value added by brand name
- Top engineers in the field
- 1/2 of sales in Non-USA market, which is expected to grow at a faster rate
- Positioned well for gaining market share among the developing middle class demographic in India & China^{xiii}
- Several top PGA, LPGA, and Champions tour golfers currently endorse the Callaway brand

Weaknesses

- Golf industry has saturated in US
- No strong opportunities to acquire companies to expand growth
- No switching costs for consumers
- Regardless of technology, the golf club market is still a market not just for functionality but also for cosmetic appeal (customer satisfaction is derived from stylistic appeal of products)
- Regulations for official golf tournaments have created problems with non-PGA conforming clubs in the past
- Must invest heavily in growth in the international market
- Possible price cap at \$500 (Consumers likely will not pay more than this)
- Decreasing volumes of purchases recently (all but Irons)

Opportunities

- Internationally, especially in Asia, golf will take off in next 10 years (developing upper-middle class)
- Utilizing Top Flite brand to launch 2nd tier clubs
- Addition of 2nd tier apparel line with Top Flite name
- Wider PGA tour player sponsorship (volume of players using clubs)
- Further diversify portfolio to other golf complements (cigars, tees, watches)
- Top Flite returning to market share dominator in golf balls (D2 ball)
- Callaway Pre-owned resale (high margin, low processing costs)

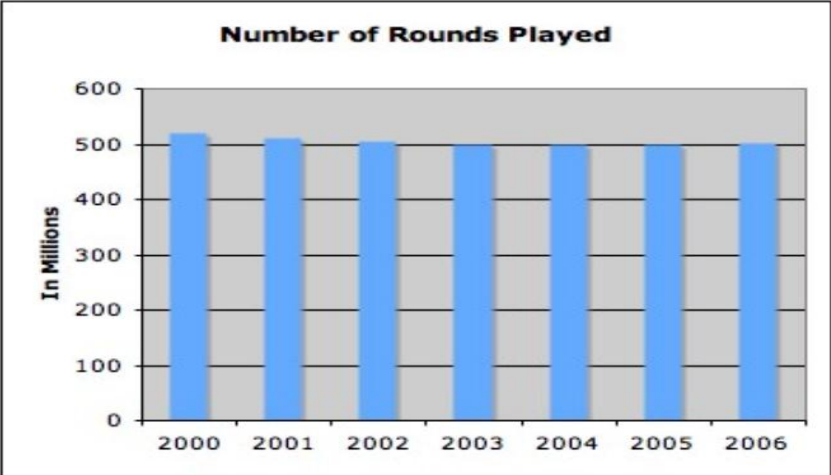
Threats

- Golf declining as a whole
- Emergence and flourishing of more specialized club makers (Yes!, Lynx, etc.)
- Asian knock-off market
- Ebay (threat to Callawaypreowned.com)
- New entrants with technology to outdo Odyssey's Putters
- Golf becoming a richer mans game again (low margin courses shutting down)
- Lifestyle changes towards spending weekends with family
- Possible plateau of distance technology (400 yd drive for senior citizen)
- List in competitive analysis section of numerous competitors (Page 9/10)
- Declining US economy discourages spending on leisure products

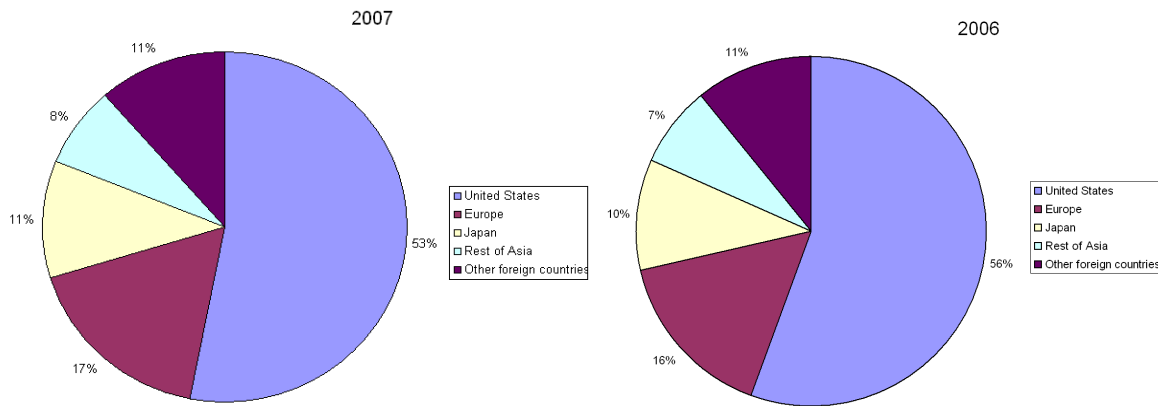
Financial Analysis

Callaway has remained a force in the golf industry over the years, and this is not changing in the present. Callaway has maintained its dominance in the industry with a strong portfolio of Woods, Irons, Putters, and Accessories. Along with their strong portfolio of current products comes the promise of equally superb pipeline products. There are always a few worries involved in the leisure market, and especially golfing equipment. The two that would seemingly affect Callaway the most would be the rational behavior of consumers and the acceptance of new designs/styles.

Over the past years, golf's popularity in the USA has decreased. Golf peaked in 2000 with the number of rounds played and the number of players who play eight or more times per year. After the Tiger Woods hysteria, which brought young people's attention away from other sports, the golf industry has largely declined. Non-major PGA tour events are nationally broadcasted less often than they used to be, and national interest has dwindled. Furthermore, the number of golfer's whom golf 8+ times per year has decreased since a high of 518 million in 2000 (501 million in 2006)^{xiv}. This decline is further illustrated by the negative course openings that occurred in 2006, in that 25 more courses closed than opened^{xv}. The following graphs represent rounds played declining:



Callaway has noticed these trends and expanded their branding strategy campaigns emerging golf markets in Europe & Asia among others. In 2007 sales out of the USA accounted for approximately 47% of totals sales as compared with 44% in 2006^{xvi}. With the proliferation of an upper-middle class in India and China on the horizon, it is important to employ strong branding strategies in those nations. Callaway has already executed on that and boosted its revenues in Asia (sans Japan) by nearly 14%. Below is a graph of the net sales breakdown by region:

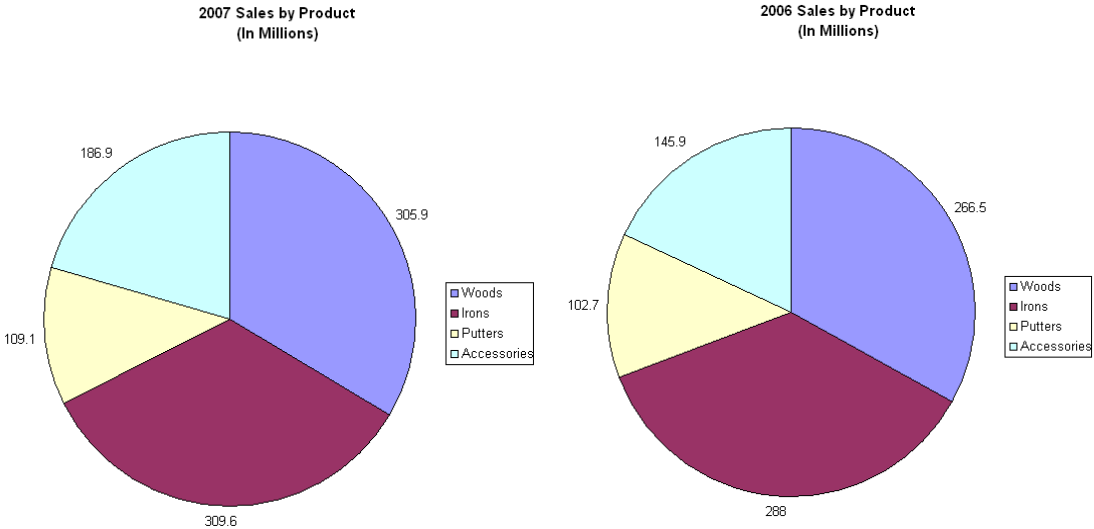


Callaway's sales of their four major divisions (Woods, Putters, Irons, & Accessories) increased by 13% in 2007 over 2006. This led to total sales of \$911.5 million compared to \$803.1 million in the previous year^{xvii}. The following will break down how the different divisions within net sales fared individually

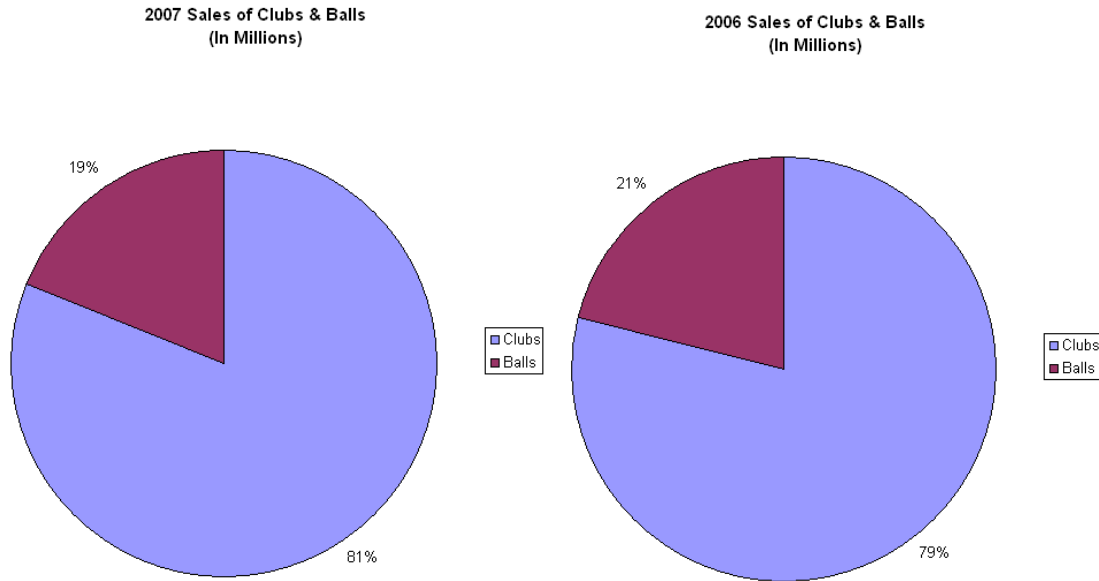
Callaway was able to capitalize on new designs and consumer behavior over the past year by posting 15% growth in Woods net sales. The introduction of the FT-I and FT-5 drivers were the main reasons for this increase. However, the downside to this is that volumes of sales of Woods were down in 2007 as compared to 2006. This one-year gain promotes questions among analysts if these increases are sustainable. With the current average number of rounds per year by golf enthusiasts eroding, the market could be headed for a downfall. The question as to whether Woods net sales are sustainable and have room to grow is whether the \$500 cap on current driver prices is the price ceiling for this industry.

This same story of increased prices but lower volume of sales also led to a growth in putter sales of 6%. The same questions arise whether the Odyssey brand has saturated the upscale putter line, or if there is still room to grow in the United States. The Irons line had similar growth of 8% but have a better prospectus for the future as Callaway Irons increased volume and prices. Iron sales felt the positive impact of having a larger selection of high-end irons to choose from which more reflected the production strategy of Titleist, TaylorMade, and Ping.

The largest revenue growth occurred in accessories in 2007. This division grew 28%, largely due to footwear, bags, and glove sales. The biggest shift in this area took place in shoe production and sales. Callaway was locked in a deal until 2006 where Callaway's shoes were sold through a licensing agreement, unlike now where they sell Callaway's footwear directly to retailers. Combined with this change is the proliferation of the Callaway shoe brand, bolstered by larger unit volume in 2007. The question arises here is if this is a one time growth due to a change in distribution networks, or if the brand itself fueled a large portion of the growth. The following graph represents the breakdown of sales from the different segments of Callaway:



One problem area for Callaway has been the fledgling golf balls segment. This is largely fueled by Callaway's 2003 acquisition of the Top Flite brand. Top Flite once had one of the top volume of sales for golf balls in the market, but lack of innovation has relegated this company to the back of the pro shop. Golf ball sales decreased 1% in 2007 because of diminishing sales of Top Flite golf balls, which was partially offset by the increased sales of Callaway Golf balls. The bright side of this perceived weakness is that even though net sales decreased, the segment was profitable, unlike 2006 when it lost \$6.4 million. The following graph shows the breakdown between golf club sales and golf ball sales:



One interesting note is that all Callaway club sales experienced substantial growth, while the golf ball segment has not^{xviii}. Presumably, a consumer shift to the Callaway & subsidiary brands would lead to growth across all products. This was not the case in 2007, as Callaway updated production facilities in order to employ more automated creation of clubs. The 4% decline in cost sales from 2006-2007 reflects this shift in production techniques. This increased operating margins in the same time period from 4.2% to 8.8%^{xix}.

Callaway has provided strong financials over the past years, and especially in 2007. EPS increased 134% from \$0.34/share in 2006 to \$0.81/share in 2007^{xx}. This diluted EPS is partially offset by the repurchasing of 1.6 million shares for a total cost of \$25.9 million. Even without this share repurchase, Callaway's activities over the past year created strong earnings growth, and they consistently beat the streets projections for earnings and profitability.

Even though Callaway has consistently beaten earnings over the past year, the stock price has not reflected this. Last year Callaway had a blow out year with double digit increases in sales, as well as improving costs with more automated factories. However, since 2006 the stock price has increased a trivial 0.88%. Combine this with a current stock price of \$14.26 that is only \$0.32 above the 52 week

low. If one compares this with the stock prices of Callaway's biggest competitors: Nike, Adidas (TaylorMade), and Fortune Brands (Titleist, Cobra, Pinnacle, etc.) Callaway is trailing all except Fortune as illustrated by the below graph:



2-Year Callaway Stock Performance Comparison with Fortune Brands, Adidas & Nike^{xxi}

This is an underdeveloped picture of the golfing market as there are a few other major players like Ping and Cleveland Golf (Japanese), which are both private companies. What this picture does show us is that the diversified sporting goods providers are doing much better than the ones that focus solely on golf. Adidas and Nike are two of the largest sporting goods providers for all athletic needs. Thus, they are not as effected by a decrease in golfing membership as a Callaway or Fortune Brands would be because it is not the sole focus.

Strategic Issues & Recommendations

The main issues featuring Callaway are a dwindling market and the lack of performance by acquisitions. The generation born from 1930-1946 has fueled the consumption of golf over the past 10-15 years, but their demographic has shrunk and the baby-boomers are choosing to spend their leisure dollar on less active pursuits. The weekend golfer has shifted to spending more time with his family, rather than disappearing on the golf course for the day. This is coupled with the increased popularity of travel, shopping, cooking, and other more social activities. With all of these factors in mind it becomes quite evident that in order to survive, Callaway must increase its market share.

Our main recommendation to the Callaway Golf Company is to utilize the Top Flite line as a way of recycling older models of clubs. Currently, the only available way that Callaway can sell to those individuals who do not want to pay \$1,000 for a set of irons or \$500 for a driver is through Callaway's used clubs website. Unfortunately, this is in direct competition with Ebay, which has better prices on the clubs in many situations. We do not view the online pre-owned business that Callaway has started as a likely long-term success because of the presence of Ebay and other online auctioneers.

Top Flite has been given some respect in the Golf world because of the recent success of the D2 golf ball line. By releasing clubs with the same or a similar name, we could capitalize on this recent recognition and bolster the brand further. We also want to ensure that the consumers know that Top Flite is associated with Callaway, thus, we would recommend that some notation were given which indicated this. A possibility would be, "D2 Drivers by Top Flite, powered by Callaway Technology." This would separate the brands, protecting Callaway if the venture failed, while also ensuring the consumer that the product is of the highest quality.

We would recommend that the production of older models of clubs re-branded under Top Flite would begin with last year's models. We would not recommend delving any further back because of the recent switches to an automated assembly method. This would not have an adverse effect on operating margins because of the shifts in production techniques. By using the same manufacturing processes with a different label, Callaway would also minimize costs of creating brand new factories. This would also limit the need to invest heavily in research & development at Top Flite while creating a substantial product line instantly.

In order to minimize cannibalization of the Callaway drivers and irons, our recommendation would be to create clubs under the Top Flite brand after two years have elapsed. The hype surrounding a new technology dies out after one season, and sales of new clubs dramatically fall after the second year. Particularly well-received products may have decent sales into the

third year, but this is rare. A two-year lag would allow for the Callaway branded clubs to maximize the sale potential, and then re-release the technology to receive heightened sales for two to three more seasons. The lag time would allow for substantial observations on the success of Callaway products. This would lead to fewer duds by Top Flite by only recreating the top technology & styles that Callaway engineers.

With a less expensive line of products, Callaway would be able to get products on the shelves of stores such as Wal-mart and Target. Given the high premiums paid on Drivers and Irons it is expected that even with deeply discounted prices that these stores require, Callaway would still make money on the sales of Top Flite clubs. This would also give Callaway a large revenue boost and access to a market that no other golf club maker has secured yet. We recommend that this move be made quickly as Nike & TaylorMade have the size and relationships to pursue a similar move.

More shelf space could also be created in stores that currently carry Callaway and Top Flite products such as the big box specialty stores like Big 5 Sporting Goods and Chick's Sporting Goods. We believe that the wide-range of customers that these stores serve would be the perfect location to sell our entire range of products. By offering clubs of all technology levels, we could sell to a Beverly Hills resident and a starving college student at the same time. When this establishes the Top Flite brand at those stores, the golf balls could be pushed onto the shelves with Ben Hogan golf balls and products as well. We foresee the proliferation of the Top Flite brand occurring the most in these specialty stores because people are still willing to head to a sports store and enjoy their experience, rather than rushing through it to save time.

Discounting these clubs would also not be a huge burden on Callaway's profit margins as research & development costs have not skyrocketed in any of the past five years. This is possibly because of the larger indicator that technology can only bring the game of golf so far. Eventually, golf clubs technology will plateau, as it is extremely unlikely that a senior citizen will be able to drive the ball 350 yards regardless of the club they wield. If this hypothesis

reigns true than the Top Flite brand could become a major player in Drivers and Iron sets because of a shift in public views on new technologies.

Lower costs could also allow Callaway to steal back market share from the counterfeiters of irons and drivers. Threats to Callaway's successful expansion abroad relies on the ability to outpace the counterfeiters that can reverse engineer Callaway's clubs and sell them at a discounted rate. If Callaway re-released old technology two to three years after initial creation, they could effectively steal some market share from the growing black market. Top Flite could also be the leading foot into India and China for the growing upper-middle class in these countries. This would further Callaway's current focus on international expansion by releasing lower cost clubs in more developing markets for Golf.

One of the many beneficial effects that introducing this new product line would have for Callaway would be the added ability to price-discriminate in the golf industry. In the typical life cycle of a club it experiences large volumes of sales at a high price in its first year, then the price and volume tapers off. With the new positioning of the Top-Flite brand clubs, Callaway would be able to increase volumes and prices during the third year of technology. This would allow Callaway to collect more of the leisure dollar that a consumer would otherwise spend on non-golfing activities as well as competitors products. This would also expand Callaway's range of quality offerings from the very top to mid-range with new clubs. This would be a new segment of sales for Callaway and could be built upon further with the creation of starter sets of clubs in the future if this branding works successfully. The table below describes how this change in pricing would increase revenue, and shows the benefit from TF given moderate estimates of sales:

	<i>P-Cal</i>	<i>P-TopFlite</i>	<i>V-Cal</i>	<i>V-TopFlite</i>	<i>Total-Vol</i>	<i>Ave-Price</i>	<i>Cal-Rev</i>	<i>TopFlite-Rev</i>	<i>Total-Rev</i>	<i>Ben from TF</i>
Year 1	800	0	100	0	100	800	80000	0	80000	0
Year 2	400	0	70	0	70	400	28000	0	28000	0
Year 3	300	500	30	70	100	440	30000	35000	65000	35000
Year 4	250	300	20	20	40	275	10000	6000	16000	6000
Year 5	200	250	10	10	20	225	4000	2500	6500	2500
Year 6	150	150	10	10	20	150	3000	1500	4500	1500

Note: Approximate prices taken from Ebay marketplace data. Volumes are estimated, guided by 10-K disclosure from Callaway. Cal = Callaway, P = Price, V = Volume of Sales, Rev = Revenue, Ben = Benefit

The wider market that could be reached by recycling old technology in a new package would increase market share enough to offset the atrophying industry of Golf. This new market share would also be complimented by the added distribution channels that Callaway would now have to products to fit into. The addition of this new line would not be damaging to the Callaway brand name because it would be through its subsidiary, Top Flite. A link would exist between these companies, but a failed Top Flite club would not be indicative of future clubs by Callaway. This move would unlock shareholder value through added revenues and alleviate analyst thoughts of hardship for Callaway because of a shrinking market by creating strong opportunities in developing regions.^{xxii}

ⁱ NGF Rounds Played Report 2006/2007

ⁱⁱ Liz Peek, "Golf industry counts on boomers to drive sales"

ⁱⁱⁱ SunTrust Initiate 03/29/2007:ELY

^{iv} Callaway 10-K SEC Report

^v <http://www.callawaygolf.com/Global/en-US/Corporate/OurHistory.html>

^{vi} <http://www.fundinguniverse.com/company-histories/Callaway-Golf-Company-Company-History.html>

^{vii} <http://finance.yahoo.com/q?s=ELY>

^{viii} Keybank research report (17 Mar 2008). Analyst: Scott Hamann.

^{ix} Nike enters the golf industry (12 Mar 2002). Final paper at GSB UChicago strategy class.

^x Callaway 10-K SEC Report

^{xi} www.pga.com Product Page

^{xii} Callaway 10-K SEC Report

^{xiii} Callaway 10-K SEC Report

^{xiv} [http://www.wikinvest.com/stock/Callaway_Golf_Company_\(ELY\)#_note-12](http://www.wikinvest.com/stock/Callaway_Golf_Company_(ELY)#_note-12)

^{xv} http://www2.nysun.com/article/60000?page_no=1

^{xvi} Callaway 10-K SEC Report

^{xvii} Callaway 10-K SEC Report

^{xviii} Wachovia Analyst Report: Timothy Conder & Jed Ellerbroek

^{xix} Callaway 10-K SEC Report

^{xx} Callaway 10-K SEC Report

^{xxi} www.finance.google.com

^{ix} Nike enters the golf industry (12 Mar 2002). Final paper at GSB UC