

Callaway Golf – Case B

Ely Callaway felt proud as he took stock of the year 1997 in his report to shareholders. Callaway Golf had yet another year of strong growth in sales, with net sales up by \$125 million from 1996. Sales in the US had increased 19% while sales to Europe and Asia had increased 46% and 20% respectively. International sales, which were ~ \$300 million in 1997 now accounted for 35% of the firm's total revenues, more than the total sales of the entire firm in 1993 (see Exhibit 7a for details on Callaway financials). In addition to its wholly owned subsidiary in the UK, Callaway Golf now had a subsidiary in Germany as well as in Japan.

Callaway Golf had consistently been the market leader in US market for Golf Clubs over the past 5 years, with an estimated market share over 25% despite the introduction of many new products by leading competitors (Ping's "ISI" Irons, Taylor Made's "Burner Bubble Shaft" Irons, Cobra's "Ti" Titanium Metal Woods, "King Cobra II" and Armour's "Ti 100" Irons; see Exhibit 4 for market shares of leading players). The use of Big Bertha drivers by professional tour players on the five major tours (PGA, Senior PGA, LPGA, NIKE and PGA European Tours) in the 1997 was 66%¹, and Callaway's two new products – the Biggest Big Bertha Titanium Driver and the Great Big Bertha Tungsten-Titanium Irons had done well with consumers and constituted over 20% of 1997's sales. Part of this success had stemmed from its continued ability to deliver new, innovative golf equipment at regular intervals since its introduction of the Big Bertha in 1992. In the preceding five years it had introduced the Great Big Bertha Drivers, the Great Big Bertha Fairway Woods, Big Bertha War Bird Metal Woods, and Big Bertha irons, most of which had been extremely successful with consumers. It continued to spend heavily on R&D, increasing expenses to \$30 million in 1997 as compared to \$16 million in 1996. In addition to its investments in R&D, Callaway had spent considerable effort in marketing and branding its image as a firm that was up-market yet accessible to 'amateur' golfers, helping to deepen its penetration in the market for woods and expand into the market for irons.

Earlier that year, Callaway had also acquired Odyssey Golf, the market leader in putters, thereby expanding its lead and breadth in the market for golf clubs. Callaway had also decided in May 1996 to enter the \$ 650 million golf ball market (see Exhibit 3b for a break down of the golf industry market by segment) by designing and building its own golf balls. As part of this effort Callaway formed the Callaway Golf Ball Company, a wholly owned subsidiary of Callaway Golf. While it did not expect to generate any revenue from this business until 2000, it continued to make further investments in this project, including investments in plant machinery in 1997, as well as in designing the prototypes for the golf balls it planned to launch within the next few years.

In addition to these large capital investments, Callaway had also opened Callaway performance centers earlier that year at Walt Disney World in Orlando, Florida, Pebble Beach Resort in Carmel, California as well as in Las Vegas. These new sites were meant

¹ Callaway 10K, 1997

to provide in-depth advice to help golfers trying to decide which model of Callaway Golf clubs would work best for them. In May 1997, Callaway also consolidated its design efforts in a new technology design center. In line with these investments, Callaway decided that the theme for the 1997 annual report would be “Technology – Investment for the Future” (see Exhibit 6a for a comparison of capital expenditures by Callaway and other competitors).

Despite these tremendous successes, some dark clouds were looming on the horizon. An unusually wet winter brought on by “El Nino” seemed to have dampened sales in the US, while the economic turmoil in Southeast Asia and Korea had impacted the golf markets in those countries and was feeding through to Callaway’s sales. Even as Callaway and its competitors continued to spend aggressively on designing and marketing new golf clubs, industry reports were cautioning that inventory levels seemed to be building up and warned against possible ‘buyer fatigue’ with the next new golf club. Callaway had just cut its prices 15% for Big Bertha clubs, the first across the board price cut for woods. On the other hand, with 932 new golf courses under construction in 1997, a favorable demographic profile in the US and a robust economy in the US with no immediate sign of slowing down, cutting back on R&D, marketing and investment in capacity could mean getting left behind by the competition.

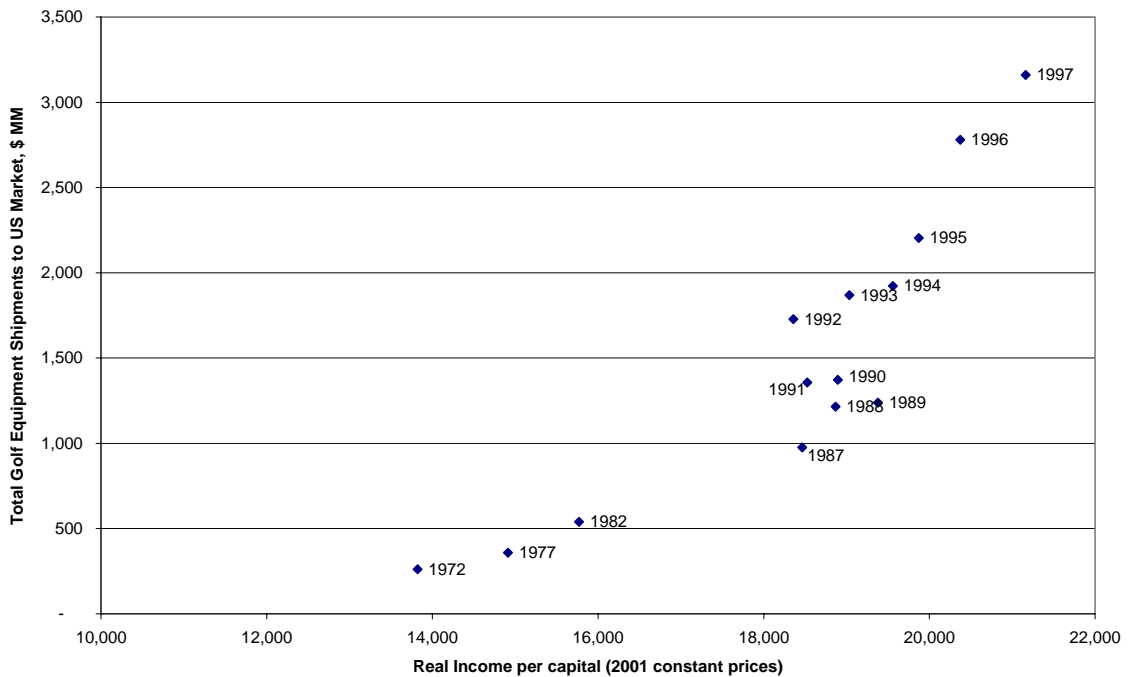
As Ely Callaway considered his options for the rest of 1998, he wondered what his strategy should be. How could he continue to ensure Callaway maintained its leading position in the market, while also ensuring the high margins and rising stock price investors had come to expect in the five years the company had been public?

Exhibit 1: Number of Golfers, Number of Golf Courses and Number of Rounds of Golf Played in the US (1970 – 1997)

Year	Number of Golfers (Million)	Number of Rounds (Million)	Number of Golf Courses
1970	11.2	265	10,188
1975	13.0	310	11,370
1980	15.1	360	12,005
1985	17.5	415	12,346
1992	21.3	505	13,210
1997	25.0	550	16,010

Source: SBI Market Intelligence Report (SB-297) on Golf Industry, October 1998

Exhibit 2 : Value of Golf Equipment Shipments to US Market vs. Real Per Capita Income in the US (1972 – 1997):



Source: SBI Market Intelligence Report (SB-297) on Golf Industry, October 1998, US Census, own analysis

**Exhibit 3a: Value of US Golf Equipment Shipped from US Plants
(1972 – 1997)**

Year	US Plant Shipments (\$ MM)	Exports (\$ MM)	Imports (\$ MM)	Shipments to US Market (\$ MM)
1972	277	28	12	261
1977	385	52	25	358
1982	644	133	28	539
1987	964	178	190	976
1988	1,246	284	253	1,215
1989	1,398	437	278	1,239
1990	1,470	402	304	1,372
1991	1,485	433	305	1,357
1992	1,768	428	389	1,729
1993	1,926	491	435	1,870
1994	1,976	541	489	1,924
1995	2,370	690	524	2,204
1996	2,648	766	589	2,471
1997	3,245	810	714	3,149

Source: SBI Market Intelligence Report (SB-297) on Golf Industry, October 1998,

Notes: (1): Golf Equipment shipments include golf clubs, golf balls, bags and related equipment

(2) Shipments to US Market = US Plant Shipments + Imports – Exports:

(3): In 1992 Japan constituted the largest export market, with ~ 32% of US golf equipment exports, followed by UK (13%) Canada (10%), and Germany (7.5%)

**Exhibit 3b: Value of Shipments to US Market and Estimated Consumer Expenditure
in US by Segment (1997)**

Type of Product	Value of Shipments	Estimated Consumer Expenditure
Golf Clubs	1,497.0	2,522.8
Golf Balls	642.6	889.0
Golf Bags	264.6	323.0
Specialty Golf Equipment	744.9	n/a
Total	3,149.1	

Source: SBI Market Intelligence Report (SB-297) on Golf Industry, October 1998, Sports Business Research Network

Note: Shipments to US Market = US Plant Shipments + Imports – Exports

Exhibit 3c: Fraction of \$ Value* and Number of Clubs Purchased by Major Distribution Channel in US (1997):

Channel	Fraction of \$ Value	Fraction of Clubs purchased
Sporting Goods Stores	15%	22%
Specialty Sports Shops	30%	25%
Pro Shops	32%	21%
Discount Stores	7%	15%
Warehouse Clubs	2%	2%
Mail Order	5%	5%
Catalog Showrooms	--	--
Online/ Internet	--	--
Other Outlets	9%	10%
	\$ 2523 MM	**

Source: SBI Market Intelligence Report (SB-297) on Golf Industry, October 1998, Sports Business Research Network.

** Note: Sources differ on the number of clubs purchased in US in 1997. Estimates vary from ~ 40,000 Clubs to ~ 70,000 clubs

Exhibit 3d: Quantity and Value of Golf Club Shipments to US Market by Type (1977-1997)

(QUANTITY IN THOUSANDS, VALUE IN MILLIONS)

GOLF CLUB TYPE	1977	1982	1987	1992	1997 E
<u>IRONS</u>					
QUANTITY	10,125	8,044	22,819	16,496	28,388
PERCENT TOTAL ¹	71.5%	68.4%	81.9%	73.4%	68.0%
VALUE	\$118.3	\$156.5	\$437.3	\$507.0	\$1,009.87
PERCENT TOTAL ¹	65.2%	55.4%	72.1%	60.1%	54.1%
AVERAGE VALUE/UNIT SHIPPED	\$11.68	\$19.46	\$19.16	\$30.73	\$35.57
<u>WOODS</u>					
QUANTITY	4,032	3,717	5,060	5,982	13,359
PERCENT TOTAL ¹	28.5%	31.6%	18.1%	26.6%	32.0%
VALUE	\$63.1	\$125.8	\$169.5	\$337.0	\$856.7
PERCENT TOTAL ¹	34.8%	44.6%	27.9%	39.9%	45.9%
AVERAGE VALUE/UNIT SHIPPED	\$15.65	\$33.84	\$33.50	\$56.34	\$64.13

Source: SBI Market Intelligence Report (SB-297) on Golf Industry, October 1998

Notes (1): Percent of Total is calculated as fraction of total of Irons and Woods.

(2) Shipments to US Market = US Plant Shipments + Imports – Exports

Exhibit 4: US Sales and Market Share of Top 25 Golf Club Manufacturing Companies (1995- 1997)

<u>COMPANY</u>	<u>1995</u>		<u>1996</u>		<u>1997</u>	
	<u>SALES</u>	<u>PERCENT TOTAL SUPPLY</u>	<u>SALES</u>	<u>PERCENT TOTAL SUPPLY</u>	<u>SALES</u>	<u>PERCENT TOTAL SUPPLY</u>
CALLAWAY	\$365	26.1%	\$449	28.1%	\$518	27.3%
TAYLOR MADE	143	10.2	242 ²	15.1	250 ²	13.2
COBRA/BOBBY GRACE	148	10.6	147	9.2	150	7.9
NORTHWESTERN/PRO SELECT ¹	86 ²	6.1	45 ²	2.8	92	4.8
PING	88 ²	6.3	89 ²	5.6	87 ²	4.6
TITLEIST	50	3.6	58 ²	3.6	75	3.9
TOP-FLITE/HOGAN	63	4.5	69	4.3	70	3.7
KNIGHT/AFFINITY ¹	29	2.1	38	2.4	51	2.7
MIZUNO	37	2.6	41	2.6	50 ²	2.6
WILSON ¹	70	5.0	46	2.9	50 ²	2.6
ODYSSEY	11	0.8	27 ²	1.7	43	2.3
ADAMS	3	0.2	5	0.3	37	1.9
DUNLOP/FOCUS ¹	41	2.9	25 ²	1.6	35 ²	1.8
ARMOUR	35 ²	2.5	53 ²	3.3	33 ²	1.7
NICKLAUS	17 ²	1.2	20 ²	1.3	26 ²	1.4
GOLDWIN	6	0.4	18 ²	1.1	26 ²	1.4
LYNX	40	2.9	39	2.4	24	1.3
CLEVELAND	33	2.4	26	1.6	23	1.2
RAM	8 ²	0.6	9 ²	0.6	16 ²	0.8
YONEX	16 ²	1.1	16 ²	1.0	15 ²	0.8
MACGREGOR	21 ²	1.5	20	1.3	15 ²	0.8
ARNOLD PALMER	NA	—	18	1.1	14	0.7
SQUARE TWO	7	0.5	8	0.5	12	0.6
POWERBILT	9 ²	0.6	4 ²	0.3	10	0.5
RAWLINGS ¹	NA	—	10	0.6	10 ²	0.5
OTHER COMPANIES	74	5.3	78	4.9	168	8.8
TOTAL DOMESTIC SUPPLY ³	\$1,400	100.0%	\$1,600	100.0%	\$1,900	100.0%

Notes: Sales to on-course and off-course pro shops and specialty golf and sporting goods stores.
 NA = Not available separately, included in Other Companies.
 Percent totals may not equal 100% due to independent rounding.

SOURCE: *Golf Pro*, May issues
 Compiled and calculated by
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1 Includes other sporting goods sales
 2 Estimated by *Golf Pro*
 3 U.S. shipments plus imports

Exhibit 5a: Worldwide Sales for 16 Public Golf Companies (\$ MM)

<u>COMPANY</u>	<u>FISCAL YEAR END</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
ADAMS GOLF, INC.	12/31	—	—	\$1.1	\$3.5	\$36.7
AJAY SPORTS, INC. ¹	12/31	—	—	—	21.6	26.0
ALDILA, INC.	12/31	\$62.6	\$79.8	56.5	58.4	55.6
THE ARNOLD PALMER GOLF CO.	9/30	18.7	24.7	24.6	21.2	28.5
ASHWORTH, INC.	10/31	45.8	60.8	74.5	75.4	89.1
BLACK ROCK GOLF CORP.	12/31	—	—	5.0	8.9	6.9
CALLAWAY GOLF CO.	12/31	254.6	448.7	553.3	678.5	842.9
COASTCAST CORP.	12/31	66.9	90.6	76.0	148.3	149.5
FORTUNE BRANDS, INC. ¹	12/31	452.7	507.1	579.3	811.4	911.6
GRIP TECHNOLOGIES, INC.	7/31	—	0.9	1.1	3.1	3.8
RENAISSANCE GOLF PRODUCTS, INC.	12/31	—	5.8	5.0	2.4	5.4
ROYAL PRECISION, INC.	5/31	—	—	—	—	21.7
S2 GOLF, INC.	12/31	8.9	8.8	7.2	8.6	12.1
SPORT-HALEY, INC.	6/30	—	—	12.6	20.3	28.9
TEARDROP GOLF CO.	12/31	—	—	—	0.8	9.6
WILSON SPORTING GOODS ¹	12/31	—	—	245.6	209.6	235.8

Exhibit 5b: Profit Margin (Op Income/ Sales) for 16 Public Golf Companies

<u>COMPANY</u>	<u>FISCAL YEAR END</u>	<u>1993</u>	<u>1994</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
ADAMS GOLF, INC.	12/31	—	—	(21.7%)	6.3%	29.6%
AJAY SPORTS, INC. ¹	12/31	—	—	—	(3.7)	(4.5)
ALDILA, INC.	12/31	25.7%	26.7%	20.4	18.2	6.7
THE ARNOLD PALMER GOLF CO.	9/30	(5.4)	(4.3)	(38.4)	(26.6)	(39.5)
ASHWORTH, INC.	10/31	14.5	13.8	4.7	4.4	9.9
BLACK ROCK GOLF CORP.	12/31	—	—	(4.5)	(18.7)	(36.4)
CALLAWAY GOLF CO.	12/31	26.9	28.2	27.9	28.0	24.8
COASTCAST CORP.	12/31	16.4	16.9	7.8	16.5	11.9
FORTUNE BRANDS, INC. ¹	12/31	14.0	14.5	14.3	13.4	7.6
GRIP TECHNOLOGIES, INC.	7/31	—	(145.1)	(299.7)	(46.6)	(31.5)
RENAISSANCE GOLF PRODUCTS, INC.	12/31	—	(61.1)	(47.7)	(104.4)	(34.3)
ROYAL PRECISION, INC.	5/31	—	—	—	—	8.4
S2 GOLF, INC.	12/31	—	—	1.9	4.6	10.1
SPORT-HALEY, INC.	6/30	—	—	—	17.6	17.7
TEARDROP GOLF CO.	12/31	—	—	—	(86.9)	(93.8)
WILSON SPORTING GOODS ¹	12/31	—	—	—	(8.7)	10.3

Source: SBI Market Intelligence Report (SB-297) on Golf Industry, October 1998

Note: (1) Sales of Golf Equipment and Accessories only

Exhibit 6a: Capital Expenditures for 11 Public Golf Companies

<u>COMPANY</u>	<u>FISCAL YEAR END</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
		ADAMS GOLF, INC.	12/31	— ¹
AJAY SPORTS, INC.	12/31	—	0.2	0.1
ALDILA, INC.	12/31	\$3.9	4.4	14.8
THE ARNOLD PALMER GOLF CO.	9/30	0.4	0.2	1.0
ASHWORTH, INC.	10/31	2.1	2.5	2.0
CALLAWAY GOLF CO.	12/31	29.5	35.4	67.9
COASTCAST CORP.	12/31	3.8	7.7	2.1
FORTUNE BRANDS, INC.	12/31	20.6	50.4	59.4
GRIP TECHNOLOGIES, INC.	7/31	0.4	0.6	0.3
S2 GOLF, INC.	12/31	0.1	— ¹	— ¹
SPORT-HALEY, INC.	6/30	—	0.8	1.2

Source: SBI Market Intelligence Report (SB-297) on Golf Industry, October 1998

Note: Fortune Brands includes the brands Titleist and Cobra,

Exhibit 6b: Advertising Expenses for 6 Public Golf Companies

<u>COMPANY</u>	<u>ADVERTISING EXPENSES</u>			<u>ADVERTISING EXPENSES PERCENT SALES</u>		
	<u>1995</u>	<u>1996</u>	<u>1997</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
ADAMS GOLF, INC.	— ¹	— ¹	\$9.2	3.1%	1.0%	24.9%
THE ARNOLD PALMER GOLF CO.	\$2.0	\$1.4	1.1	8.1	4.9	3.9
ASHWORTH, INC.	0.5	0.4	0.6	0.7	0.5	0.7
BLACK ROCK GOLF CORP.	2.6	3.8	2.7	52.0	42.7	39.1
CALLAWAY GOLF CO.	12.1	18.3	20.3	2.2	2.7	2.4
SPORT-HALEY, INC.	—	0.5	0.5	—	2.5	1.7

Source: SBI Market Intelligence Report (SB-297) on Golf Industry, October 1998

Exhibit 7a: Select Callaway Financials

(in thousands, except per share data)

	Year ended December 31,				
	1997	1996	1995	1994	1993
Statement of Income Data:					
Net sales	\$842,927	\$678,512	\$553,287	\$448,729	\$254,645
Cost of goods sold	400,127	317,353	270,125	208,906	115,458
Gross profit	442,800	361,159	283,162	239,823	139,187
Selling, general and administrative expenses	191,313	155,177	120,201	106,913	67,118
Research and development costs	30,298	16,154	8,577	6,380	3,653
Litigation settlement	12,000				
Income from operations	209,189	189,828	154,384	126,530	68,416
Other income, net	4,576	5,767	4,017	2,875	1,184
Income before income taxes and cumulative effect of accounting change	213,765	195,595	158,401	129,405	69,600
Provision for income taxes	81,061	73,258	60,665	51,383	28,396
Income before cumulative effect of accounting change	132,704	122,337	97,736	78,022	41,204
Cumulative effect of accounting change					1,658
Net income	\$132,704	\$122,337	\$ 97,736	\$ 78,022	\$ 42,862

Source: Callaway Annual Report, 1997

Exhibit 7b: Breakdown of Worldwide Callaway Sales by Product Group

WORLDWIDE CALLAWAY GOLF CLUB SALES BY PRODUCT GROUP, 1995-1997

(MILLIONS OF DOLLARS)

<u>PRODUCT GROUP</u>	<u>1995</u>	<u>1996</u>	<u>1997</u>
METALWOODS	\$382.7	\$479.1	\$544.3
PERCENT TOTAL	69.2%	70.6%	64.6%
IRONS	\$140.6	\$168.6	\$234.0
PERCENT TOTAL	25.4%	24.8%	27.8%
PUTTERS, ACCESSORIES, AND OTHER	\$29.9	\$30.8	\$64.7 ¹
PERCENT TOTAL	5.4%	4.5%	7.7%
TOTAL CALLAWAY GOLF SALES	\$553.3	\$678.5	\$842.9

Note: Columns may not add to total due to independent rounding.

SOURCE: Company financial report
Calculated by
SPECIALISTS IN BUSINESS INFORMATION

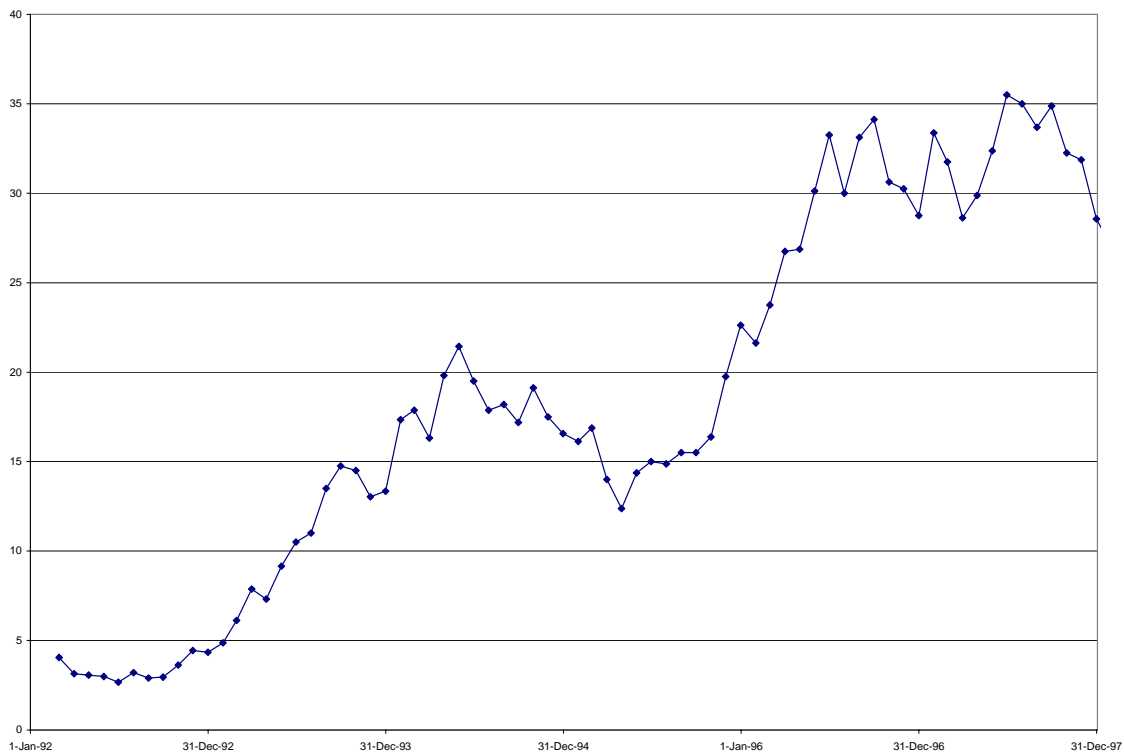
¹ Includes \$20.5 million for Odyssey putters and wedges acquired in August, 1997

**Exhibit 7c: Breakdown of Worldwide Callaway Sales by Geography
(Thousand \$)**

Country	1995	1996	1997
United States	367,359	460,611	547,256
Japan	60,971	58,156	84,634
All Others (individually less than 10% of Net Sales)	124,957	159,745	211,037
Total	553,287	678,512	842,927

Source: Callaway Annual Report, 1997

Exhibit 8: Callaway Golf Stock Price from IPO to December 31, 1997



Source: CRSP Database at wrds.wharton.upenn.edu