



Callaway Golf (ELY)

An iconic brand with significant untapped value

January 24, 2014

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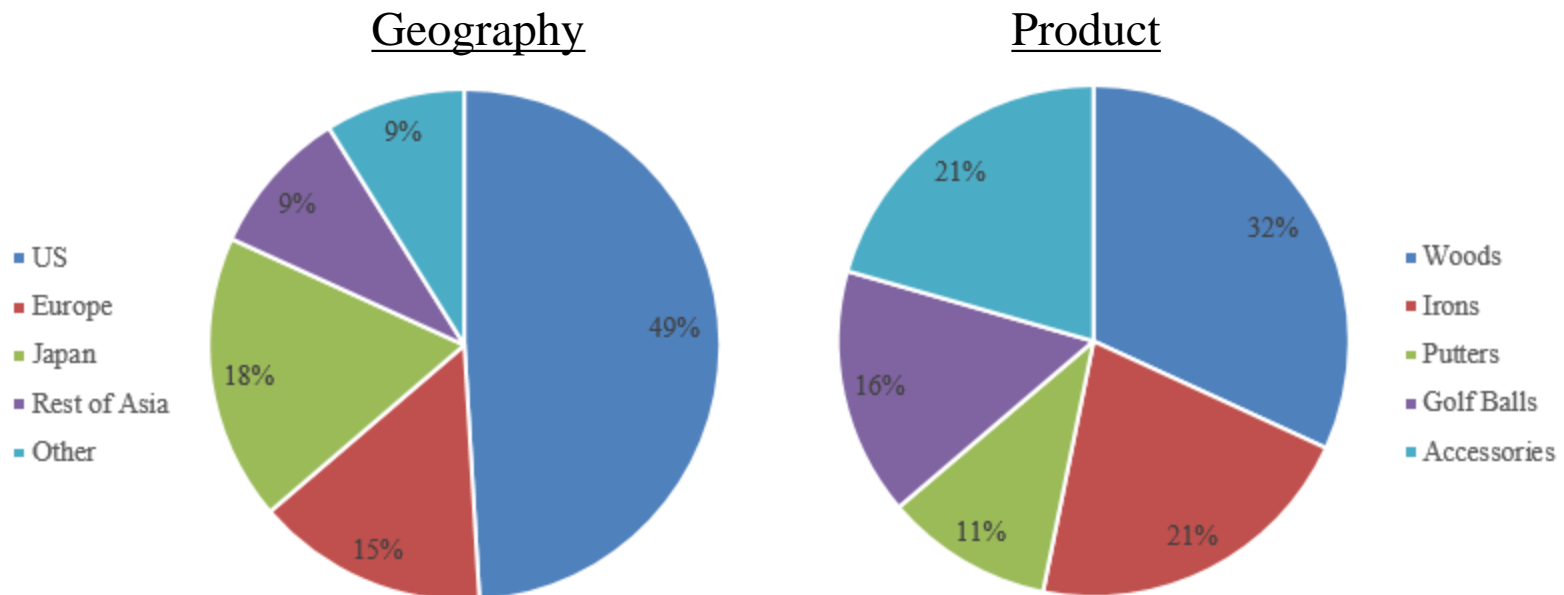
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Company Description

Callaway Golf is a leading global golf equipment manufacturer founded in 1982 and based in Carlsbad, California. The Company sells golf clubs including drivers, fairway woods, hybrids, irons, wedges and putters, as well as golf balls and accessories under the Callaway and Odyssey brands.

In 2012, Callaway earned revenues of \$834 million, broken down by geography and product as follows:



Recent Company History

ELY has performed poorly since 2008 as the Company's competitiveness and profitability diminished. The stock has increased 40% over the past two years as new management executes its strategy and sentiment improves.

- New CEO hired in February 2012
- Sold Ben Hogan to Perry Ellis in February 2012
- Sold TopFlite to Dick's Sporting Goods in April 2012
- Announced a \$52mm cost reduction plan in July 2012
- Refinanced senior debt by 375bps in August 2012
- Redeemed convertible preferred stock in October 2013

Price (1/24/14)	\$9.01
Shares	<u>72.6</u>
Market Cap	\$654.6
Debt	107.7
Cash	<u>37.4</u>
Enterprise Value	\$724.8



Investment Thesis

Callaway has re-emerged under the new leadership of CEO Chip Brewer and is positioned to gain market share and improve profitability. The Company has assets with underappreciated value, and in the long-term, there exists the opportunity for a sale of the business.

Key Levers:

1. New CEO
2. Cost structure realignment
3. Brand improvement
4. Monetization of assets

New CEO Chip Brewer

Chip Brewer joined Callaway in 2012. Previously he spent 14 years with Adams Golf, ten of which as CEO when he sold the business to TaylorMade for 0.9x sales in 2012. During his tenure at Adams, Chip grew revenue 175% to \$104 million. Chip owns only 20,000 shares of ELY stock but has 800,000 stock options that vest ratably over a three-year period at an exercise price of \$6.48 with an expiration of March 2017.

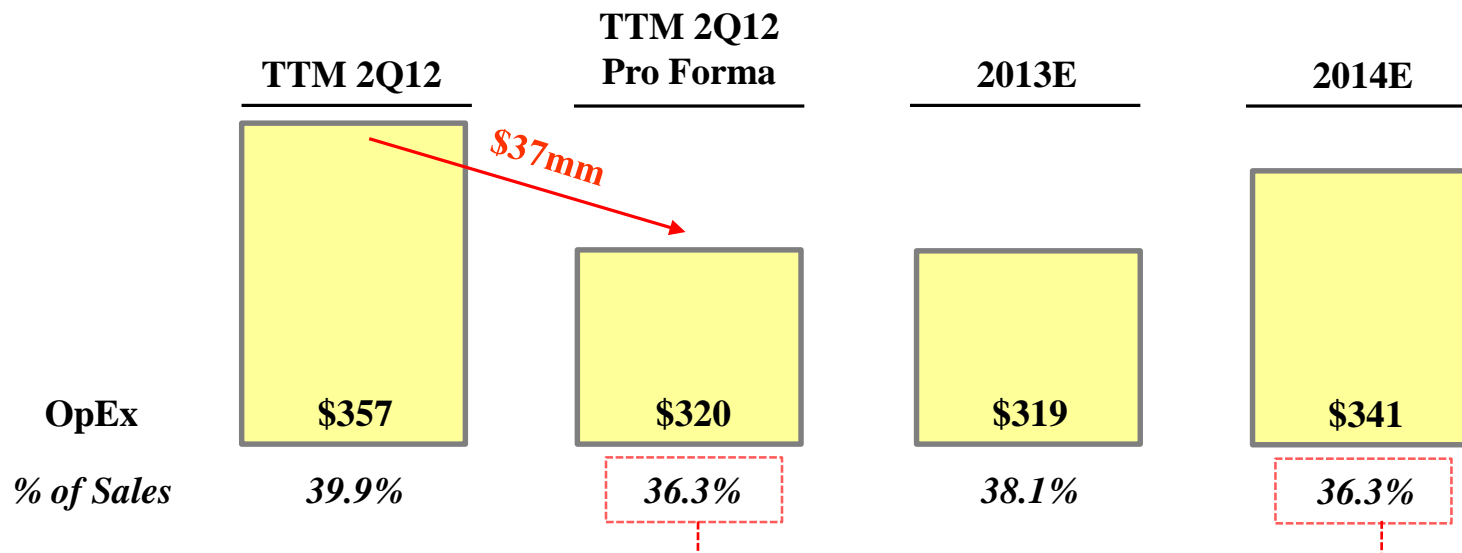
Strategy

1. Cut costs
2. Improve product image
3. Recover market share
4. Maximize shareholder value



Cost Structure Is Right Sized

- Callaway announced a \$52 million cost savings plan in July 2012, \$15mm in cost of goods sold and \$37mm in operating expenses
 - 12% reduction in global work force
 - Restructured golf ball operations to be profitable at 2H12 volumes
 - Sold non-core Top-Flite and Ben Hogan brands
 - Transitioned to a license model for apparel and footwear business
- Cost to implement savings plan is \$40 million over 12 month period
 - 3Q13 first clean quarter, operating expense as a percent of sales down 1,430bps y/y



Brand Image

Callaway's sales improved in 2013 due to a reinvigorated product portfolio and momentum should accelerate in 2014 as CEO Brewer had a full year to innovate.

- Introduced X-Hot club line in 2013, re-launched Big Bertha drivers in 2014 and introduced new Speed Regime ball in 2014
- Sponsorship headliners include Phil Mickelson, Henrik Stenson and Jim Furyk
 - ELY is pruning its sponsorships and betting on younger professionals like Patrick Reed, Harry English, Nicolas Colsaerts and Chris Kirk
- Callaway signed Ryo Ishikawa in January 2013
 - Japan accounts for 18% of sales and grew 7% in 2013 (+31% excluding FX)

PCC Value Add Research:

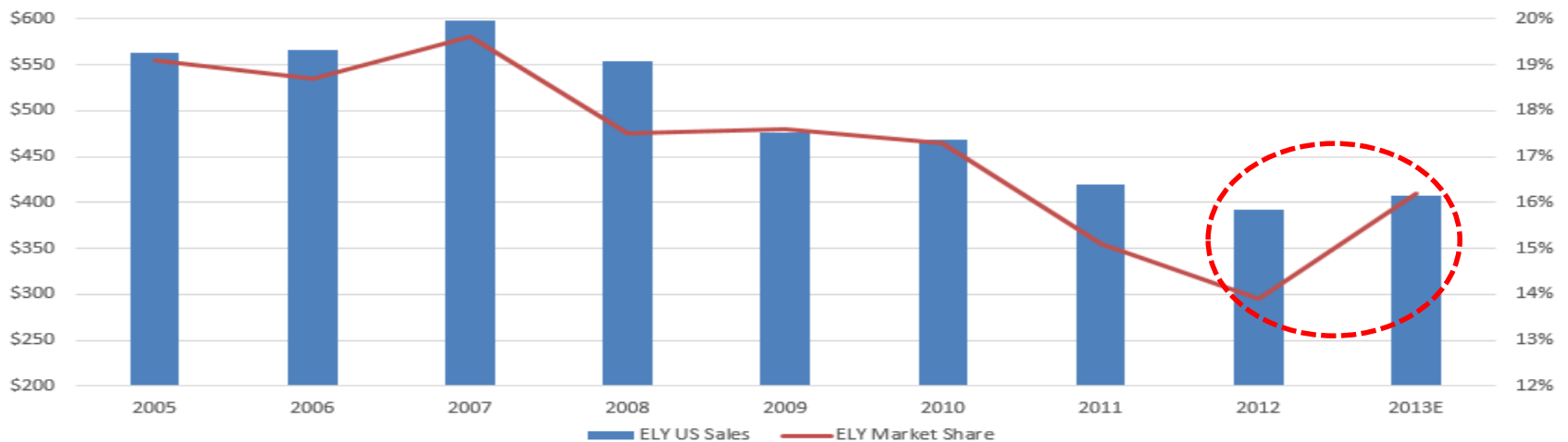
- *Checked retail stores and talked to sales associates*
- *Attended the PGA Merchandise show in Orlando in January*
- *Talked with management of private golf clubs and golf technology companies*

Key takeaway from PGA Merchandise event is that customers think the new Big Bertha driver will be the #1 selling driver on the market in 2014.

Recover Market Share

Callaway ceded 570bps of market share in the US between 2007 and 2012 as sales declined 34%. The US accounts for 50% of ELY's sales.

- Difficult golf market in 2013 due to poor weather conditions, which resulted in rounds played -6% through September 2013 vs. +6% in 2012
- ELY hard good unit market share increased 270bps y/y to 16.2% as of 11/13; management's goal is to get back to low 20%



Industry expectations are for positive growth in 2014 on the back of better weather, improving consumer discretionary spending and easier y/y comps.

ELY Valuation

	2010	2011	2012	2013E	2014E	2015E
Revenue	\$967.7	\$886.5	\$834.1	*\$838.3	\$938.9	\$1014.0
<i>Growth y/y</i>		-8.4%	-5.9%	+0.5%	+12.0%	+8.0%
Gross Profit	365.5	311.3	248.2	326.9	389.6	430.9
<i>Margin</i>	37.8%	35.1%	29.8%	39.0%	41.5%	42.5%
OpEx	384.6	392.4	364.5	319.4	340.8	360.9
<i>% of Revenue</i>	39.7%	44.3%	43.7%	38.1%	36.3%	35.6%
EBIT	(19.1)	(81.1)	(116.3)	7.5	48.8	70.0
D&A	41.0	38.6	33.2	26.0	26.0	26.0
EBITDA	21.9	(42.5)	(83.1)	33.5	74.8	96.0

*2013 revenue growth +1%, ex. divestitures +6% and ex. FX +13%

EV/EBITDA	8.0x	9.0x	10.0x	11.0x	12.0x
Enterprise Value	\$767.7	\$863.7	\$959.6	\$1,055.6	\$1,151.6
Net Debt	(70.3)	(70.3)	(70.3)	(70.3)	(70.3)
Market Value	697.5	793.4	889.4	985.3	1,081.3
Shares	72.6	72.6	72.6	72.6	72.6
Price	\$ 9.60	\$ 10.92	\$ 12.24	\$ 13.56	\$ 14.88
<i>Upside</i>	7%	21%	36%	51%	65%

Based on a historical 10.0x EV/EBITDA multiple, we believe ELY is worth \$12.24 per share or 36% upside, but there exist two additional value levers...

Unlock Shareholder Value

Park City Capital believes several interested buyers for a brand like Callaway exist and management is likely to explore a sale of the business over the next couple years as the turnaround matures.

Date	Buyer	Seller	Price	Sales	P/S
10/2013	Altamont Capital	Mervin Manufacturing	\$52	\$32	1.6x
9/2013	Paulson & Co.	Steinway Musical	\$512	\$359	1.4x
12/2012	Mitsubishi Rayon	Aldila	\$25	\$48	0.5x
6/2012	Black Diamond	Poc	\$44	\$23	1.9x
3/2012	Taylormade	Adam's Golf	\$70	\$104	0.7x
5/2011	Fila Korea	Acushnet	\$1,225	\$724	1.7x
2/2010	Puma	Cobra Golf	\$140	\$200	0.7x
11/2007	SRI Sports	Cleveland Golf	\$133	\$56	2.4x
				Avg.	1.4x

ELY 2016E Sales \$1,055	1.2x	1.4x	1.6x
Stock Price	\$14.86	\$17.40	\$20.34
<i>Upside</i>	<i>65%</i>	<i>92%</i>	<i>118%</i>

TopGolf Investment

Callaway owns ~17% of TopGolf, which is a small but successful driving range retail concept based in Dallas, TX. TopGolf is accelerating unit growth and we believe it may try to go public in the next 3-4 years. The minority stake is classified as a non-current asset on the balance sheet and the Street ascribes little value to it.

In Millions	2013E	2016E	TAM
Avg. Units	9	35	120
Revenue/Unit	\$11.0	\$11.0	\$13.0
Revenue	\$99.0	\$385.0	\$1,560.0
<i>EBITDA Margin</i>	<i>40.0%</i>	<i>40.0%</i>	<i>40.0%</i>
EBITDA	\$39.6	\$154.0	\$624.0
<i>ELY Stake</i>	<i>17.0%</i>	<i>17.0%</i>	<i>17.0%</i>
ELY EBITDA Contribution	\$6.7	\$26.2	\$106.1
<i>% of ELY 2014E EBITDA</i>	<i>20.1%</i>	<i>78.0%</i>	<i>316.2%</i>

At 10.0x 2016E EBITDA, Callaway's stake in TopGolf could be worth \$3.60 per share or 40% of the current stock price.

Valuation Scenarios

Market share gains

12 months

\$12.24

10.0x 2015E EBITDA

Upside 36%

Company sale

3 Years

\$17.40

1.4x 2016E Sales

Upside 93%

TopGolf IPO

Option

+\$3.60

\$21.00

10.0x 2016E EBITDA

Upside 133%

Risks

1. Market share gains do not materialize
2. Increase in product discounting by competitors
3. Number of rounds of golf played declines
4. Negative trends in GDP growth, unemployment or discretionary spending
5. Management decides not to put the Company up for sale
6. Deterioration in market opportunity for TopGolf
7. TopGolf management decides not to pursue an IPO