

GILFORD SECURITIES GOLF INDUSTRY RESEARCH



2015 PGA Merchandise Show Report



TaylorMade Gets Religion (and the Business Says Hallelujah!)

2014 in Context

The past year has been marked with an onslaught of mass media reporting on the difficulties of the golf industry to an extent unforeseen in prior years. Those working and/or vested in the game have been aware of the problematic trends of participants/rounds played in the US for a decade now. With a shortfall in earnings at Dick's Sporting Goods (Symbol: DKS; Not Rated) as the catalyst, the mass media almost comically approached the story as 'Breaking news!'

As Dick's eliminated 500 PGA professional positions working in their golf departments, they were reversing a mistake made years before that had never produced the return expected on investment, but the media also seized on this data point as a tragic example of how the business of golf was driving off a cliff. Somehow the media left the public with the impression that these 500 PGA professionals were turning down assistant pro jobs at Augusta so they could work at Dick's. The reality is that the business of golf has been slowly gliding downhill for a decade and the mass media just woke up to that fact.



What really happened at Dick's started with the fact that we experienced an extremely cold spring over a significant portion of the country, delaying the start to the traditional club buying season. At the same time, depending upon what source you prefer, either TaylorMade arm-twisted Dick's into buying too much inventory or Dick's begged them to get as much inventory on hand as they could get (it doesn't matter which at this point in time). The TaylorMade advertising and marketing program for the TaylorMade JetSpeed launch was a disaster (puppets and cartoons) reminiscent of the original Callaway golf ball launch over a decade ago (comparing their golf balls to moon-dust and lizard skin). Needless to say, between the inventory, the weather, and the failed marketing program, Dick's ended up with way too much TaylorMade inventory which ultimately had to be flushed at prices well below the original MSRP. The situation at Dick's was not unique. It was similar at almost every distribution point in the U.S. Dick's was just the most visible focal point.

In the Dick's conference call when they discussed their poor results, Dick's didn't throw their most important vendor under the bus (and shouldn't have), so naturally they spread the blame around threw the entire business under the bus, with 500 PGA professionals to boot. It became a media firestorm, and has left the public with an impression that the golf industry is in dire straits.

TaylorMade suffered 20-30% sales declines (depending upon what quarter you look at), but surprisingly the other major equipment companies were mostly able to manage through it and in some cases even grow. **Callaway Golf (symbol: ELY; Rated Buy) is expected to report their first annual profit since 2008 later this week, a significant achievement against the backdrop of negativity.** Our sources suggested that Titleist and Ping also had reasonable success during 2014 despite the media firestorm.

It is not our intent to minimize the problems that faced TaylorMade and Dick's during 2014. It is simply important to point out that the media waking up to the longer term issues confronting the golf industry does not necessarily mean that everyone suffered equally.

For Every Action...

We spent last week at the 2015 PGA Merchandise Show gathering impression about how 2015 might stack up for the golf club equipment industry. The trip included meetings with at least a couple dozen industry CEO's and senior executives. What we learned we believe bodes well for the entire industry.

The keywords for 2015 are 'Inventory Control'. For years every golf equipment company fought uphill against not just the dominant market share enjoyed by TaylorMade, but also against the overwhelming in-field inventory position. In 2011 and 2012 customers were confronted with a blizzard of white product when they walked into specialty off course retailers and sporting goods stores like Dick's. The customers ate it up, but still the excess inventory caused problems for everyone. The flushing of that inventory cost retailers margin and gave competitors ulcers.

When the combination of weather, a mis-marketed product launch and a huge inventory position meant that the inventory flushing started almost before the selling season even began, TaylorMade finally had to concede that their strategy had risks not only for the competitors, but for themselves as well.

For 2015 TaylorMade has a new CEO. Ben Sharpe (formerly head of European Golf operations) has taken over the role from industry legend Mark King. Through multiple conversations with several sources we have determined that TaylorMade has a new found respect for tightly managing field inventories. This leads us to believe that holding full pricing much deeper into the year and maintaining gross margins is of paramount importance. Assuming this conclusion is correct, **we believe TaylorMade could actually be more profitable in 2015 while selling less units!**

Our opinion is this is a win-win for TaylorMade and for the business in general. TaylorMade could potentially make more money by holding full pricing deeper into the year. The retail distribution channel will be thrilled beyond belief if discounting of product can be pushed out to 2H. The competition will almost certainly participate in a positive way because TaylorMade has been the price leader for several years now. If TaylorMade shows more discipline in pricing, the rest of the business will likely follow and benefit proportionally.

The Big 4.5

We proposed about a decade ago that through consolidation and failure, that the golf club equipment business would grind down to 3-4 global competitors with dominant market shares, and the rest, would be consolidated (like Adams Golf), fail to survive (MacGregor among others) or fade into a marginal position (too numerous to list). Our sense is we have pushed closer to that day,

Titleist dominates the golf ball business. Ping, Adidas/TaylorMade and Callaway Golf all have large global presences. Callaway was at serious risk of fading out, but has been brought back to a stronger position with new management. We are sure to hear protests from Puma/Cobra, Srixon/Cleveland and others, but when judged by the global book they just don't carry quite enough heft.

The 0.5 is Nike Golf. Nike is just such a strong global brand that it's hard to just throw them out of the conversation. Nike Golf also has a new CEO for 2015, Daric Ashford (formerly managing Brand Jordan). Nike Golf has always had a powerful golf apparel business, but has always been

looked at as sort of a lesser competitor when it came to golf equipment, principally because their product was not deemed to be compelling enough. But they are so powerful otherwise that we are loath to drop them from the global brand position.

2015 Products

The global power brands matter for the following reason. When we are asked questions like “Did you see that new Bridgestone driver?” the answer is a resounding “No!” And the reason is Bridgestone is *highly* unlikely to have a driver that is likely to have a meaningful market share *globally*. Could it do really, really well in Japan? Of course it could. But it is still highly unlikely to matter market share-wise globally.



Since TaylorMade’s issues in 2014 had such an impact on the total business, it makes sense to discuss what we saw from TaylorMade products for 2015. The first word that came to mind when examining the 2015 line was ‘Clean’ and we sense that TaylorMade is trying to return to the offerings that made them so successful in the first place. The equipment line-up is tightly positioned around two basic woods lines and an iron line that has three variations.

R15 Woods: The R15 driver is an extension of the popular R series of woods, and features a ‘double SLDR’ sliding weight system. It looks fancy, is back in the popular white, and feels great. The Company is using the white driver to try to retake the impressions from the PGA tour telecasts, a strategy that served them so well in the past. The fairway woods seemed a little smaller in the head, but we believe these are the first fairway woods to offer a sliding weight on the bottom of the sole. The utility wood was a dead-on copy of the old Adams Pro utility wood. Our guess is as TaylorMade is repositioning the Adams brand, they are trying to move those tour professionals using the Adams Pro up to the parent TaylorMade brand.



AeroBurner Woods: The AeroBurner woods are an extension of the old RocketBallz woods. Our opinion is the fairways are larger in the head and look really easy to hit and feel great. The driver

feels fine; we just wonder if the AeroBurner has no adjustability, is this a feature that the public has just come to expect in a driver and will bypass this club due to the lack of adjustability? We will just have to wait and see.



RS Irons: The RS irons come in RS1, 2, and TP. The TP series is for the Tour Player (TP). Very few players as a percentage of the golfing population should be considering that one. RS1 is an extension of RocketBladez and SpeedBladez irons from the last two years, now featuring a cut through slot in the face of the irons as well as the sole. So presumably, the entire face has multiple flex points. We could see how that adds distance, but we're not sure how that *controls* distance. The RS2 professes to control distance better while keeping maximum flex. It seems that differentiating between the two products may cause some confusion, but they have a clean look from the top and feel a little softer on the ball, particularly in comparison to the SpeedBladez.



Titleist

915 Driver and ProV1 Golf balls: Titleist has a new driver (915). Titleist has new golf balls. "Meet the new boss. Same as the old boss." We find their new products to be virtually indistinguishable from their old products. They look the same, feel the same, and probably play the same. The single most important fact that we learned about Titleist new products is that the urethane cover on the Pro-V golf balls will not re-melt once they have been molded onto the core. We didn't know that was a problem (outside the odd fourteen year-old with a blow torch) but that doesn't make the achievement any less impressive. One thing is new about the golf ball; the \$62 MSRP.

This impression is undoubtedly intentional. Titleist has an incredibly successful franchise and is unlikely to break the mold, so to speak. In the meantime, they continue on with the AP1 and AP2 irons, the Vokey wedges and the Scotty Cameron putters. It's hard to argue with success.

PING

G30 Driver: Our sources say that the new Ping G30 driver has had the hottest start of any driver Ping has ever made. We tried it and we have to admit it felt very good. The wing tips on top of the crown didn't intrude and in fact served as a decent alignment device. Our only objection was the sound, which we could best describe as 'tinny'. We can't forget the old Ping Ti ISI drivers, which had a bang like a firecracker. The G30 has a clank like a soup can. Those who can overcome this will probably love the club.



G30 Irons: The G30 irons appear to be engineered with the express desire to make them look like the Ping Eye2's from the address position. There is even more weight in the bottom of the club, promoting ease in getting the ball airborne, and those nostalgic for the old Ping Eye2 days (which many dedicated Ping customers always are) will easily gravitate to these irons.



Ping Glide Wedges: The new Ping Glide wedges were created with the idea that the sole is constructed in such a way as to assist the club in gliding through the rough. Without putting

them into play, it is difficult to determine the veracity of the claim. But we did like the weight and feel of the club, the head felt slightly lighter than most wedges which left the impression that we were in control of the shot. The sole sat nice on tight turf and clipped the ball with a nice feel. Ping wedges used to be a non-factor, and they are improving an growing in relevance over the years.



Nike Golf is the enigma of the golf club equipment business. After all, having Tiger and Rory *should* be an unassailable marketing advantage, and yet somehow Nike can't seem to break through. Since the consumer survey conducted by The Sports & Leisure Group contends that consumers would just a soon see non-golf people endorsing and using a company's products, Nike could tap their vast sports-star portfolio to bring golf to new groups of interested eyes. Let's see Nike Soccer, or football stars using Nike clubs and enjoying golf.

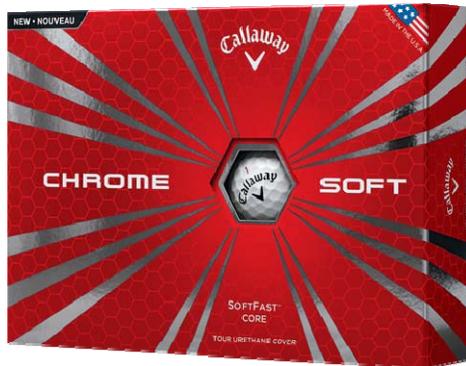
Vapor Speed Driver and Irons: As it relates to this year's equipment, we would highlight a couple of vast improvements; the Vapor Speed Driver and the Vapor Speed irons. In the Vapor Speed driver Nike finally made a driver that doesn't feel hollow or sound lousy, and gets the same kind of feedback on the face as some of the more popular drivers. In the Vapor Speed irons they have created a set that has some of the characteristics of utility irons, and the feeling off the face is excellent. It seems almost counterintuitive that the clubs that feel the best are so called game improvement clubs, but that seems to be the case.



Method Adjustable Counterbalanced Putter: We also give Nike credit for the counterbalanced Method putters with adjustable counterweights in the grip.



Chrome Soft Golf ball: From all available accounts, the Callaway Chrome Soft golf ball has broken from the gate with a red hot reception. We have often said that in order to grab meaningful market share in the golf ball business, you can't try to make a ball 'that's just as good as a ProV1'. You have to do something risky that will differentiate your ball from their ball. Callaway has done that with the 65 compression Chrome Soft ball, and they may have struck gold since Phil Mickelson is putting the ball into play. Since the removal of Top-Flite from the Callaway Golf ball business, Callaway has improved margins and reduced costs and is now making money in the golf ball business. Remarkable, after at least a *decade* of losses in the golf ball business.



XR Family: The Callaway XR family of drivers, fairways, hybrids and irons are stepping into that distance slot that the X2 Hot clubs occupied. With the momentum that Callaway has with the X line, we suspect that these are going to continue to do well.



Big Bertha Irons: But the biggest shock was the new Big Bertha irons. We went on a launch monitor/simulator and every shot felt flush no matter where we hit it on the face. The chamber in the head of the longer irons gave a pure hybrid feel. We suspect that more and more players are going to demand this feel in longer irons as all players have become inured into the hybrid model. If it's good in a four iron substitute, why wouldn't that feel be just as acceptable in a seven iron configuration? At \$900 a set, we suspect that anyone who tries them is going to have to seriously consider putting them in the bag.



Odyssey Works Counterbalanced Tank Versa Putter: Lastly, the counterbalanced Tank putter from Odyssey is a natural for those that have to move off the long and belly putters in the next year. The heavy head with the counterbalanced weight in the grip is the best solution, especially for those that preferred long putters who are used to very heavy putter heads.



SUMMARY – We believe that with a greater attention to inventory control, the entire golf equipment industry will exhibit better profitability in 2015. Discounting will be far less prevalent unless we have another significant weather issue in late Q1/early Q2 (which is impossible to forecast). The 4-5 largest companies will dominate market share, and have solid product sets. We believe that Titleist will continue to dominate the golf ball category.

TaylorMade will still have the largest share of equipment, but the business will be more balanced than it has been in recent years. Ping, Callaway, Nike and Titleist all have strong equipment products. Callaway will improve their golf ball share, but most likely at the expense of balls other than Titleist.

Going out on a very thin limb, we will guesstimate that rounds played domestically are going to rise in 2015 for the first time in years. Simply put, it's just hard to imagine that the weather in the months of March, April and May can be as bad as we have experienced the last two years in multiple geographies. We fully expect industry watchers to write that down and call us to task if we are wrong on this forecast.

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I, Casey Alexander, certify that all the views expressed in this research report accurately reflect my personal views of the subject company (ies). I also certify that I have not and will not receive compensation with respect to the issuance of this report.

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Our Rating on Callaway Golf is Buy.
 The Author does not have a position in Callaway Golf
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