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EDITED TRANSCRIPT

ELY - Q1 2017 Callaway Golf Co Earnings Call

EVENT DATE/TIME: MAY 04, 2017 / 9:00PM GMT

OVERVIEW:

ELY reported 1Q17 consolidated net sales of $309m and fully-diluted EPS of $0.27. Expects 2017 non-GAAP net sales to be $960-980m and non-GAAP EPS to be $0.31-0.37. Co. also expects 2Q17 non-GAAP net sales to be $290-300m and non-GAAP fully-diluted EPS to be $0.28-0.31.

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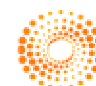

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PRESENTATION

Operator

Good afternoon, ladies and gentlemen, my name is Karen and I will be your conference operator today. At this time, I would like to welcome everyone to the Callaway Q1 2017 Earnings Conference Call. (Operator Instructions) I would now like to turn today's call over to Mr. Patrick Burke, Head of Investor Relations. Please go ahead, sir.

Patrick Burke

Thank you, Karen, and good afternoon, everyone. Welcome to Callaway's First Quarter 2017 Earnings Conference Call. I'm Patrick Burke, the company's Head of Investor Relations. Joining me on today's call are Chip Brewer, our President and Chief Executive Officer; Brian Lynch, our General Counsel and interim Chief Financial Officer. And Jennifer Thomas, our Chief Accounting Officer. Any comments made during the call about future performance, events, prospects or circumstances, including statements related to estimated 2017 net sales, gross margins, operating expenses, taxes and earnings per share, estimated share count, future industry or market conditions, the future impact from change in foreign currency rates, the success of the 2017 products, the creation of long-term shareholder value, the collectability of accounts receivable and salability of inventory, estimated 2017 capital expenditures and depreciation and amortization expenses, estimated transaction and transition costs related to the OGIO acquisitions, the ability to benefit from the company's net operating loss carryforward as well as other statements referring to future periods and identified by words such as believe, will, could, would, expect or anticipated, are forward-looking statements subject to safe harbor protection under the federal securities laws. Such statements reflect our best judgment today based on current market trends and conditions. Actual results could differ materially from those projected in the forward-looking statements as a result of changes to or risks and uncertainties inherent in the company's business or factors affecting the company's business. For details concerning these and other risks and uncertainties, you should consult our earnings release issued today as well as Part 1, Item 1A of our most recent Form 10-K for the year ended December 31, 2016, filed with the SEC, together with the company's other reports subsequently filed with the SEC from time to time. Also during the call, in order to provide a better understanding of the company's underlying operational performance, we will provide certain of the company's results and projections: one, on a constant-currency basis, which essentially applies to prior-period exchange rates to the adjusted current or projected future periods financial information as though such prior-period rates were in effect during the current or future period; two, excluding the tax consequences related to the reversal of the valuation allowance or applying an assumed statutory tax rate; three, excluding the gain on the second quarter 2016 sale of a small portion of the company's Topgolf investment; four, excluding the estimated OGIO transaction and transition expenses; and five, excluding interest, taxes and depreciation and amortization expense. This information may include non-GAAP financial measures within the meaning of

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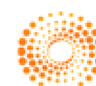

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Regulation G. The information provided on the call today and the earnings release and related schedules we issued today, include a reconciliation of such non-GAAP financial information to the most directly comparable financial information prepared in accordance with GAAP. The earnings release and related schedules are available on the Investor Relations section of the company's website, at www.callawaygolf.com. Please note that in connection with our prepared remarks, there's an accompanying PowerPoint presentation that may make it easier for you to follow the call today. This earnings presentation is available for download on the Callaway Investor Relations website under Webcast and Presentations tab. Also on the same tab, you can choose to join the webcast to listen to the call and view the slides. As a webcast participant, you are able to flip through those slides. As they go through their prepared remarks, Chip and Brian will queue the audience to inform you of when to advance to the next slide. So feel free to follow along with the materials. I would now like to turn the call over to Chip.

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Thanks, Patrick. Good afternoon, everybody, and thank you for joining us for today's call. Starting on Page 4 of the presentation. And in all fairness, let me apologize for this in advance, but I can't resist it. I believe it's fair to say that Q1 2017 was an epic quarter for our company. Sorry about that. I can almost hear the groans through the phone lines even on mute. Seriously though, we are pleased to announce performance that exceeded our expectations based on an outstanding reaction to the Jailbreak technology in our EPIC Driver as well as a successful startup of our new business ventures, Callaway Apparel Japan and OGIO. In addition, our core equipment business delivers strong performance across most product lines in all major regions. On a market share basis, for the quarter, we believe we were the #1 driver and #1 hard goods brand in the U.S., U.K., Japan and Korea. As mentioned, our new business ventures are both off to strong starts and are meeting or beating our expectations on revenue and profitability. As a result, we are increasingly convinced that these ventures are going to be accretive and create shareholder value over the long run. I'd like to take this chance to thank the Callaway Golf team for delivering these results. This is a true team effort encompassing all facets of our business, both domestically and internationally. The team should be proud of what we've accomplished. I'm also sure they understand we have a lot more to do.

Turning to Slide 5. Over the last several years, we have delivered these results despite headwinds from currency and choppy market conditions, including major contractions in the U.S. specialty retail channel over the last year. Fortunately, although market conditions vary on a global basis, overall, we see improvements in this area as well. In the U.S. there are clear signs of more stable conditions thanks to reduction in field inventory and a resizing of the channel. Average selling prices have been increasing, product life cycles have lengthened and there is less overall unplanned promotional activity. There are also fewer participants on the OEM side. In addition, the National Golf Foundation recently released its report on participation which shows stability in the committed base of on-course golfers and increase in interest to try the sport and growth in nontraditional or off-course participation, such as through Topgolf or Callaway as a significant investor. I'm not ready to claim golf as a high-growth market, but I am pleased with the trends and I believe the market corrections, irrespective of any short-term turbulence, will benefit the industry in the long run.

Turning to the financials, with highlights on Slide 6. We are very pleased with our financial position. Our liquidity and financial flexibility remain very strong and our financial performance continues to improve as evidence in our gross margin and earnings projections. Over the last 12 months, we successfully generated considerable free cash flow. As a proxy to this, our adjusted EBITDA is up 33% during this period, which we believe we have, in turn, successfully deployed for the long-term benefit of shareholders. These reinvestments include the before-mentioned new business ventures as well as strategic investments in our core equipment business and the selective repurchase of our own stock, an opportunity we took advantage of aggressively in Q1 with $15 million of purchases at an average price of $10.70 per share.

Turning to Page 7, we'll now take a deeper look into our Q1 operational performance by region. In the U.S., our revenues were up 12.4% driven by the outstanding market reaction to our EPIC Driver, strong performance across most of our product line and the acquisition of OGIO. For the quarter, our hard goods market share was 26.4%, up 480 basis points year-over-year and we held the #1 dollar market share position in total clubs, driver, fairway, hybrid and irons, as well as the #1 unit position in putters. The golf ball market was slightly more promotional than the normal in Q1, however our brand and distribution strength allowed us to perform well without having to match others' promotions. Our Q1 ball market share was 14%, up 180 basis points versus last year and up 20 basis points for 2016 full year. We believe we have strength across all premium distribution channels and have been especially pleased with our growth in the green grass channel over the last year and this continued into Q1. The U.S. market for balls and clubs combined was down slightly in the quarter, with balls up slightly and clubs down slightly. We are anticipating improved market conditions for Q2 and the balance of the year.

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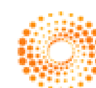

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Turning to Page 8. Our Asia business also had a strong quarter led by Japan. Our revenues from the Japan market were up 18.4% during the quarter, driven by the addition of our Callaway Apparel JV and strong market share performance in our core equipment business and partially offset by soft market conditions overall. Our hard goods dollar share for the quarter was 21.5%, up 660 basis points year-over-year, and we were both the #1 hard goods and the #1 driver brand in this market.

Moving to Page 9. In Europe, the team continued their track record of strong performance with revenues up 22% on a currency-neutral basis. This was driven by favorable market conditions in this region and strong market share growth. Our Q1 market share data for the U.K. shows us to be the #1 driver, wood and hard goods brand in that market. It also shows considerable growth in our golf ball share. Our hard goods share of 25.8% is up 650 basis points year-over-year and establishes a historical high for us in this market. And European data is only available through February, but also shows significant growth, places us as the #1 hard goods brand and shows share growth in virtually every product category.

Turning to Slide 10. On the product side, we continue to focus on premium performance products where we can differentiate ourselves in the marketplace. This has been a keystone of our strategy and all objective evidence suggests it's resonating with consumers. Recent third-party research shows that our brand rating in clubs and balls are both trending positive as is purchase interest in our products.

Now on Slide 11. Looking forward, we are pleased to be able to raise guidance for the year based on the strong operating performance and what we believe will be more stable and thus favorable year-over-year market conditions for the balance of the year. We are as confident as ever that our business is headed in the right direction and that we'll be successful in creating long-term shareholder value. Brian, over to you.

Brian P. Lynch - *Callaway Golf Company - Interim CFO, SVP, General Counsel and Secretary*

Thank you, Chip. Starting with Slide 13. Today we are reporting consolidated Q1 2017 net sales of $309 million compared to $274 million in Q1 2016, an increase of almost 13%. This reflects an increase in net sales in all major regions. Foreign currency negatively impacted international net sales by $1.6 million in Q1. The core business increased 2.9%, driven by the EPIC line of woods and golf balls, partially offset by iron launch timing, the reduction of retail doors associated with the Golfsmith bankruptcy and our retailers globally wanting to start the season with less inventory. The balance of the increase, 9.8%, was driven by our new businesses, the Japan joint venture, which began in July 2016, and OGIO, which we acquired in early January. As you can see on Slide 13, gross margin was 47.8% in Q1 2017 compared to 48.3% in the prior year, which is better than we expected as a result of better pricing and mix of products sold. The slight decrease compared to 2016 reflects the different economics of the Japan and power joint venture and the OGIO businesses, which have lower gross margins and lower relative operating expenses as compared to the company's golf equipment business. Once the integration is complete, it is expected that the new businesses will have overall higher operating margins as compared to the company's core equipment business. Operating expense was $104 million in Q1 2017, which is a $17 million increase compared to $87 million in Q1 2016. This is driven by the addition of operating expenses related to the new business ventures and the OGIO nonrecurring transaction and transition expenses which were $4 million in the first quarter. Other expense was $5 million in Q1 2017 compared to other expense of $6 million in the prior year. The 2017 amount was driven by losses from foreign currency contracts, partially offset by a reduction of interest expense as liquidity continues to improve. Pretax income was $39 million in Q1 2017 compared to pretax income of $40 million in Q1 2016. When excluding the nonrecurring OGIO expenses, pretax income for Q1 2017 was $43 million, an 8% increase compared to 2016.

Fully diluted earnings per share was $0.27 or 96 million shares in the first quarter of 2017, which includes taxes of $13 million compared to $0.40 for the first quarter of 2016, which includes taxes of only $1 million. Due to our prior deferred tax valuation allowance, we did not recognize U.S. income tax expense in the first quarter of 2016. In late 2016, we reversed almost all of the valuation allowance, and therefore, in the first quarter of 2017, we once again began recognizing U.S. income tax expense. However, we will continue to benefit from our prior net operating losses to reduce our actual cash tax liability.

The increase in U.S. income tax expense and the OGIO nonrecurring transaction and transition expenses account for all of this decrease in earnings per share. On a non-GAAP basis, which excludes the nonrecurring OGIO expenses and applies a 3.5% tax rate to normalize Q1 2016 results, the company would have reported earnings per share for the first quarter of 2017 of $0.30 compared to earnings per share of $0.26 for the first quarter of 2016.

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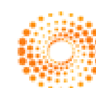

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Okay, turning to Slide 14. I will cover certain key balance sheet and cash flow items. As you can see, cash and equivalents was up 37% year-over-year to $48 million, which includes the impact of the OGIO transaction completed in January 2017, which we financed by cash on hand and a small amount from our asset-based loans. With regard to our asset-based loans, we had $77 million of borrowings at quarter end, which was 3% lower than the borrowings a year ago. Available liquidity, which includes cash and equivalents plus borrowing capacity under the asset-based loans was $173 million at quarter-end, an increase of over 16% versus prior year. We are very pleased with this increase in liquidity given our recent deployment of capital for the Japan joint venture, the OGIO acquisition and the share buybacks which amounted to $17 million in the last 12 months. We believe we are demonstrating our ability to generate free cash flow in the core business and are finding good opportunities to deploy that excess capital in the core business and in tangential areas. Our consolidated net accounts receivable were $245 million, an increase of 5% compared to 2016. DSOs decreased to 73 days compared to 81 days last year. We remain comfortable with the overall quality of our accounts receivable at this time. Also displayed on Slide 14, our inventory balance decreased by 4% to $179 million at the end of 2016, driven by the successful sell-through of the EPIC woods and balls among other product lines. Excluding the inventory from the Japan joint venture and OGIO, our inventory balance decreased by 11%. We remain comfortable with the quality of our inventory at this time. Capital expenditures for Q1 2017 were $6 million, a year-over-year increase of $1 million due to investments in our ball plant. Depreciation and amortization expense was $4 million in Q1 2017, which was about flat compared to Q1 2016. Finally, in the first quarter of 2017, the company repurchased 1.4 million shares of stock for approximately $15.4 million in cash. This includes both open market purchases and shares acquired through the settlement of equity awards. I'll now comment on our increases to 2017 guidance.

As you can see on Slide 15, we are providing both GAAP and non-GAAP guidance. The non-GAAP guidance excludes approximately $7 million of nonrecurring transition and transaction expenses, resulting from the OGIO acquisition which closed in mid-January. For my comments, I will focus solely on the non-GAAP estimates in my comments.

As seen on Slide 15, net sales are estimated to be in the range of $960 million to $980 million, an increase of $89 million to $109 million over the prior year or 10% to 13% net sales growth. Due to an overall strengthening of foreign currencies since the beginning of the year, we currently estimate the changes in foreign currency rates will adversely affect projected 2017 net sales by approximately $16 million as compared to our prior estimates of $28 million. On a constant-currency basis, we are projected to grow 12% to 14%, including approximately 4% from the core business and approximately 9% from the new businesses. We estimate that full year 2017 gross margin will increase to 45.2%, an improvement of 100 basis points compared to previous guidance, driven by continued favorable pricing and mix as well as operational efficiencies. As you can see on the slide, operating expenses are estimated to be approximately $383 million, an increase of $16 million compared to prior guidance, driven by variable costs related to higher sales and performance, the impact of foreign exchange, as well as targeted investments in the core business. Earnings per share are estimated to be $0.31 to $0.37, a year-over-year increase of $0.07 to $0.13 or 29% to 54%. These figures are all based on 96 million shares outstanding.

We are also assuming a 36% tax rate for 2017. Pro forma 2016 results exclude the Topgolf gain and the benefit from the reversal to the deferred tax valuation allowance. We continue to estimate our capital expenditures in 2017 to be approximately $25 million to $30 million. Depreciation and amortization expense is still estimated to be approximately $18 million in 2017.

Turning to Slide 16, I will now discuss Q2 2017 non-GAAP projections. Again for this slide, I will focus on the pro forma guidance column that excludes nonrecurring OGIO transaction and transition expenses. Net sales for the second quarter of 2017 are estimated to be in the range of $290 million to $300 million, an increase of $44 million to $54 million or 18% to 22% net sales growth compared to the second quarter of 2016. The increase in net sales is anticipated from continued market share gains, incremental sales from the Japan joint venture and the OGIO acquisition, and a higher proportion of reorder business from a retail perspective. Second quarter non-GAAP 2017 earnings per share on a fully diluted basis is estimated to be in the range of $0.28 to $0.31 compared to $0.12 in the second quarter of 2016, which excludes a Topgolf gain and applies an assumed estimated statutory rate of 30.5%. That concludes our prepared remarks today. We will now open the call for questions.

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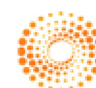

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Scott Hamann of KeyBanc Capital Markets.

Scott W. Hamann - *KeyBanc Capital Markets Inc., Research Division - Director and Senior Equity Research Analyst*

Chip, just in terms of your comments on the overall market, you seem to be a little bit more optimistic than you typically are for the balance of the year. Is the improvement in that as well as your guidance -- is your guidance -- I guess, is your guidance kind of tied to the improvement in the overall market or the share gains that you guys are experiencing as a company? How should we think about that balance?

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Yes, hey Scott. It's both. It's tied to both, as you would expect. If you look at the U.S. market in particular, and the markets are kind of varying globally, as you would expect, but the U.S. market for hard goods was actually down in Q1. I think it was down 3.9% for hard goods as measured by Datatech, which some of that is to be expected with the change in retail channels and, more specifically, the Golfsmith bankruptcy which reduced the retail channel considerably. But there was also a soft March. I think that soft March was primarily weather and that the markets are a little healthier than Datatech would've indicated through Q1. So as you mentioned, cautiously optimistic, it'll be an improved market for the balance of the year as related to the first quarter.

Scott W. Hamann - *KeyBanc Capital Markets Inc., Research Division - Director and Senior Equity Research Analyst*

Okay. And I'm kind of curious on maybe some of your additional thoughts on EPIC launch. Just kind of -- you obviously launched a lot of drivers and woods in the past and this is obviously significantly more successful than anything else by what we can tell. My observations were you guys did a lot of demo days, early fittings and it seemed like maybe that drove some earlier demand or more robust demand. I guess, maybe the question is around, just thoughts on what you might have done differently to be as successful. I mean, the custom fitting component, I think obviously works for everyone in the business. And is that something that you could kind of take that blueprint and move that forward into additional product launches to get a better result like you did with EPIC?

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

I think that you are correct and the results would indicate EPIC is just a phenomenal product. It really excites consumers and the technology in that product with Jailbreak is real. It's delighting consumers and this is the most exciting driver launch that I've ever been part of in my career. It would have been hard to predict the leadership positions that were showing on a global basis in the woods and the driver category, even though we have considerable brand strength. So it really has exceeded expectations and the team across the board has done a wonderful job in support of it. The ops team in terms of supply and manufacture, what is one of the most difficult and complicated products to make that we've ever designed. Obviously, R&D team, sales and marketing and creating the excitement and the demo days and the events, it really benefits from multiple factors. But as with our strategy, in general, it's the product that really sets it apart, Scott. This is an exceptional driver that the consumer, when they hit the product, it gives them a wow effect or it is DSPD in [Healey's] terms, however you want to say it. But that's the primary difference there. And that's why we invest aggressively back in the business and that's why you see us spend the money we do on the R&D side and building the foundation to deliver these types of products. So it's a fun one to be a part of and we are obviously very proud of it.

On the custom fitting side, Scott, that continues to be a great trend. The EPIC Driver itself has a large custom fitting component to it with adjustability built into the product. But that business and our infrastructure to support it is both great trends and continues to grow really on a global basis. So we'll be including that factor in many, if not all, of our products going forward. It's a competitive advantage for Callaway.

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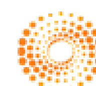

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Scott W. Hamann - *KeyBanc Capital Markets Inc., Research Division - Director and Senior Equity Research Analyst*

Okay, last one for me is on green grass. Can you just comment on kind of tilt the season at green grass through the winter, where did you kind of end up with adding distribution in the channel?

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Green grass is one of our most exciting channels, it's been a lot of focus on that here and it's been a key driver of growth. It's essential for the golf ball category, which is obviously very important to us. Over the last few years, we've been successful in adding more distribution there and that trend has continued. Our growth in the green grass channel is up significantly, double digit, and it includes further increases in door count and distribution. So that trend is alive and well and remains a key strategy for us.

Operator

Your next question comes from the line of Randy Konik of Jefferies.

Unidentified Analyst

This is John [Madaviski] on the line for Randy. I guess, just to start off with OGIO, I know it's early on, but can you comment on any early learnings following the acquisition, any color on kind of early steps of integration, whether that be on the front end in terms of sales or back end in terms of supply chain, would be helpful.

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Sure John, happy to do that. It's very early days on the OGIO acquisition. As you know, we completed and announced that in early January and are really in the middle of that transition and integration process right now. And it's a complicated one. We have made the business decision to relocate that business from Utah to Carlsbad, California. This very week, we welcomed a whole group of new employees to the Carlsbad headquarters. We went live on our IT systems and we've been working our way through that integration process methodically, and so far, successfully. I'm not going to get into a lot of details on it, but I can tell you that we continue to be very optimistic on this acquisition. It is slightly ahead of what our expectations were both on a revenue and a profitability perspective. We're months into it, though, not even more than a few of those. So lots of work to do but the team is doing good work and I'm energized about the potential of that brand and business. So stay tuned in the quarters and years ahead. We think that's going to be a very attractive new business for us here at Callaway and very positive for the shareholders.

Unidentified Analyst

And then just lastly, on some of these new business ventures. Clearly, they're off to a good start. Does that give you greater appetite for more tuck-in acquisitions in the near term because of their success? And can you just remind us of some of your priorities as you're thinking about potential acquisition targets?

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Sure. It does, actually, John. One of the things that I think we're trying to establish a reputation for is being good operators. And certainly, within the Callaway results, we hope that comes across and now as we have had the opportunity because of our increased financial flexibility and performance to try some of these new business ventures, the apparel business in Japan, the OGIO business, getting those off to strong starts does encourage us and we're optimistic regarding those -- the potential going forward.

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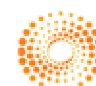

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Operator

And your next question comes from the line of Dan Wewer of Raymond James.

Daniel Ray Wewer - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Chip, I want to ask about EPIC and product shortages, particularly for the Sub Zero model.

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Sure.

Daniel Ray Wewer - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Feedback from the top core specialty retailers suggest there is still a 2- to 3-week backlog in orders. And if you feel like that negatively impacts -- you had great revenues, obviously. But do you have any sense of how much is left on the table?

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Dan, yes. There were some product delays and shortages during the quarter and when your demand exceeds your expectations by the magnitude that it did for us, which is a first-class problem, some of that does happen. I don't think it's at the point where it creates any consumer backlash and I think the supply team did a wonderful job. We have very close contact with our customers out there in the trade and they recognize the strong performance and, as a result, inventories are in a good position. It's true if you placed a new order for a Sub Zero Driver, you would wait a few weeks. But they're also out in the field as well. So I think it's a healthy balance right now. I don't think it has done anything but positive things relative to the brand given the demand and in my opinion, it's been well managed.

Daniel Ray Wewer - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Second question I had, still on the X golf ball. I know that the plans were for this to be incremental, to take share from competitors rather than cannibalize the Chrome Soft business. Do you have a sense of it played out that way? Or was there some cannibalization on Chrome Soft?

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

There was some cannibalization of Chrome Soft, Dan. But I think we expected some of that and overall, the franchise continues to be strengthened. I was really pleased with the -- in essence, the brand strength that we've shown and that continuing to be able to generate increases in market share really on a global basis now. Despite a category that was more promotional than normal during the first quarter. I think that our product strategy and differentiated product around the SoftFast cores is continuing to resonate and the X has been well received.

Daniel Ray Wewer - *Raymond James & Associates, Inc., Research Division - Research Analyst*

When you refer to promotions, are you talking about competitors offering by 3 dozen get 1 dozen free, you're getting for free.

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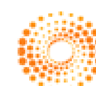

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Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Those and others, multiple competitors were doing and I'll call them volume discounts during the quarter. Sometimes that occurs as a regular occurrence. But I think it was more prevalent in the first quarter than normal and you can see that we believe we have the brand strength not to have to participate in that and a differentiated product and the results so far have been encouraging.

Daniel Ray Wewer - *Raymond James & Associates, Inc., Research Division - Research Analyst*

The last question I have is if you could help explain the segmentation strategy between Callaway branded golf bags and OGIO. It looks to me like perhaps there's some redundant marketing expenses promoting those brands. But if you could help explain why it's beneficial to maintain 2 brands.

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Yes. I think that it's early days on this, but I think the brands are very different. Obviously, Callaway is an authentic OEM golf equipment that is very well established in the marketplace. OGIO, fresher, newer, a little more -- it's not tied to any one brand manufacturer. So some people like to buy a bag that doesn't have the same brand name, if you would, of their irons or driver, and they don't want to have it be matchy match, if you would. Some people would like to buy a bag that has a little bit more of an edgy or stylish approach to it. That Callaway being a more traditional brand, it may not fit with. And it allows us to segment the market. We're going to be very vigilant in keeping OGIO completely separate from the Callaway brand. But we do think we'll be able to provide some synergies in terms of reach and distribution and marketing and supply chain. So I'm confident there's lots of room for both those brands and as we move forward, we'll be able to differentiate them.

Operator

(Operator Instructions) Your next question comes from the line of David King of Roth Capital Markets (sic) [Partners].

David Michael King - *Roth Capital Partners, LLC, Research Division - Senior Research Analyst*

I guess, it sounds like the U.S. market's showing signs of improvement. I guess, Chip, what are your updated thoughts on the health of some of the other markets: Europe, Asia. And then outside of the strong performance in woods, anything you can share about performance in some of the other club types in some of those other international markets?

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Sure. David, the markets are a little mixed on that front. So we've already talked about the U.S. market, it was a little bit of a soft start, but I'm optimistic for the balance of the year. On the European side, all the data is extremely encouraging and that market was up significantly during Q1. So that has been a very encouraging development. Our market shares in that market are up considerably and as I remember it, up in virtually every category. So all strengths over there. In Japan and some of the other Asian markets, they've been softer. Japan was down as a market in Q1. And -- but our market share performance was once again extremely strong with market share gains in virtually every category and ball.

David Michael King - *Roth Capital Partners, LLC, Research Division - Senior Research Analyst*

Okay. It's good color. And then maybe on the guidance for the year, it's like $0.10 or so of EPS, and I appreciate the color in the slides. It looks like expenses are up in the guidance and then also, I would've thought that gross margins beyond what you did outsized in the first quarter, there would have been more flow through in the next 3 quarters. I guess, what's driving those changes, if you can provide any color there?

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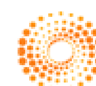

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Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Sure. I'll look at the expenditure side of it. So we did suggest in our guidance that expenditures are going to be higher for the balance of the year or for the full year than what we had previously anticipated. Several reasons for that. Little bit of currency in there. And there's some incremental spend for the balance of the year. There's the variable expense associated with the revenue increases. There's some personnel changes expense in there and there's some further targeted spend in the marketing side of the business that we think is in the best interest of the company. So there was an increase, and I believe it was $16 million, correct Brian?

Brian P. Lynch - *Callaway Golf Company - Interim CFO, SVP, General Counsel and Secretary*

Yes.

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

On the OpEx relative to our previous guidance that we think is in the best interest of the business. And on the margin, we're pleased with the outlook on that. Do you have any color on that, Brian?

Brian P. Lynch - *Callaway Golf Company - Interim CFO, SVP, General Counsel and Secretary*

No, I think, somewhat, the new businesses are slightly dilutive to gross margin level and then the operating expenses are usually a little better. So the operating margin is better but it can be a little dilutive to the gross margin.

Patrick Burke

Hey Dave, this is Patrick. We did take the gross margin guidance up 100 basis points up from the last guidance. So there is some flow through on what's happening with the core business, for sure.

David Michael King - *Roth Capital Partners, LLC, Research Division - Senior Research Analyst*

Yes, I saw that. I would've thought that maybe if the rest of this is doing better, then maybe we get a little bit more in the second, third and fourth from that. But it sounds like it's some of the other businesses, the newer ventures, that are maybe affected in that way.

Brian P. Lynch - *Callaway Golf Company - Interim CFO, SVP, General Counsel and Secretary*

In some ways, on the top line, some of that improvement versus prior guidance is the FX rate improvement in a -- better FX rates for the balance of the year and a lot of that is hedged so it doesn't flow all the way down. And our flow through now is a little bit different than it has been in the last few years, because we now have to pay -- recognize U.S. income tax, where in prior years, we do not.

David Michael King - *Roth Capital Partners, LLC, Research Division - Senior Research Analyst*

Okay. Okay, that makes sense. And then one last one for me, in terms of EPIC, what are sort of the high-level thoughts, Chip, in terms of being able to use that as a platform for other products. Is there an opportunity to do that? Forgive the ignorance, but are there any aspects of Jailbreak technology that can be conducive to other club types? I guess, just what are the big picture thoughts there?

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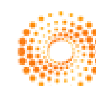

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Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

The big picture thought, David, is that it's a phenomenal technology that's clearly resonating with consumers in the driver category and you're -- got a good thought there on whether we can extend that or not. So we will, obviously, take a look at that.

Operator

Your next question comes from the line of Mike Swartz of SunTrust.

Michael Arlington Swartz - *SunTrust Robinson Humphrey, Inc., Research Division - Senior Analyst*

Chip, maybe just a follow-up on the golf ball promotional environment that you saw on the first quarter. I guess, how much of that was from a competitor that went out of business and there's some clearance closeout ball out there that the channel's working through versus a step up from some of the remaining competitors? And how does that look as we sit here in May?

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Mike, it was all relative to existing competitors. I was not referencing any of the business that has been in process of exiting. Although, I'm sure there was some impact on that. I was not thinking about that. And as we sit here in May, it has slightly improved relative to that first quarter.

Michael Arlington Swartz - *SunTrust Robinson Humphrey, Inc., Research Division - Senior Analyst*

Okay. And second question, just in terms of operating leverage, you guys have been pouring a lot of resources over the past couple of years into sales, marketing, R&D, and obviously, we're seeing the impact of that last couple of years in terms of market share. I guess, going forward, is there a point where you really can start to leverage that a little more fully or is this something where 27% of sales and selling and kind of the high 3s in R&D is the right way to think about the business longer-term?

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Well, it's an interesting question, Mike. Because clearly, operating leverage is important and it's one way to create shareholder value. So we're attentive to that. And operating leverage can be -- if you're looking at it from the OpEx expense, as your definition of operating leverage as opposed to operating margin, I see the reason for the question because we have found, what we believe, are prudent investments that show up in the operating expense line. We're very focused on creating improved financial performance and you can see it in our top line in our gross margin and our operating margin and our EBITDA. It's not as always as evident in our OpEx. And I think it is probably appropriate to look at it more holistically as opposed to one area of it. The new business ventures, they will provide OpEx leverage, if you would, or operating expenses as a percentage of revenue in those businesses is lower. And their operating margin as a percentage of operating profitability are higher. Their gross margins are lower. We're pleased with our direction overall, the fact that we're able to grow our adjusted EBITDA 33% over the last year. We'll continue to be attentive to the operating expenses. But we're also pleased at times that we can find good ways to reapply to whether it be in marketing or R&D or in other areas that allow us to deliver products like Jailbreak and we think we're representing the best interest of the shareholders in some of those expenditures. So very long winded answer to the OpEx as something we are attentive to, but when we find good ways to apply capital in that area, sometimes we'll see the results in other areas.

Michael Arlington Swartz - *SunTrust Robinson Humphrey, Inc., Research Division - Senior Analyst*

Understood. And then just final question, I think you had referenced it earlier in the call, and you just kind of, I guess, reiterated it, that gross margin at OGIO and with the Japanese JV are currently lower than the corporate average but I think you said, over time, you expect them to be higher

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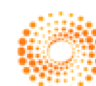

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than the corporate average. So maybe give us a sense of what the big drivers of that change are? And then, I guess, the time frame for that changing gross margin?

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Mike, I think we might've confused you on that, and I apologize. So the gross margins in those businesses are lower and we anticipate that they will probably stay lower than our core business. So they're going to be dilutive to our gross margin. That's why our gross margin in Q1 was down slightly. It's just a mix effect of these new businesses. Their operating expenses as a percentage of revenue are also lower. Their operating margin, if you would, or the profitability of the business, the contribution as a percentage of revenue are actually at or higher. So they would be dilutive, we think, ongoing. We think we'll make some improvements on that, but at this point, we do expect them to be dilutive from a gross margin perspective and a help on our operating margin percentage.

Operator

Your next question comes from the line of Andrew Burns of D.A. Davidson.

Andrew Shuler Burns - *D.A. Davidson & Co., Research Division - VP and Senior Research Analyst*

Chip, I think you get to use the EPIC description this time, but it just means now we all have to find another catchphrase for our note Titleist.

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

I think you get to use it once too. I think once and we're all done, Andrew.

Andrew Shuler Burns - *D.A. Davidson & Co., Research Division - VP and Senior Research Analyst*

Fair enough. I was hoping you can spend a little bit more time on the EPIC platform from the perspective of, I believe, this was the first product from the advanced design group. And I was wondering, how you think about annual product introductions and then layering in this longer-term, multi-year R&D investment in the pipeline that creates. How you see that playing out in the coming years?

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Yes, that's a really complicated one. You're right, this is a product that, I believe, in some ways originated out of an advanced research investment that we made several years ago -- 3, 4 years ago. An incremental investment in the operating expense as a business that is now allowing us to have a differentiated position and I'm really excited about it. Having the financial flexibility in our business to make these types of investments in a marketplace where I don't think everybody can or does, will differentiate us. We've got a great R&D team. We made some other investments recently on the ball side and it's going to be fun to see how they develop over the next few years.

How it layers into the product, cadence and cycles? That's a difficult one, Andrew, because, first of all, I don't know the answer to it and second, it's dynamic. And unfortunately, third, if I knew the answer, I couldn't tell you, because of competitive reasons. You can see that our product life cycles are lengthening. You can see it's positive on our working capital, on our cash flows, on our margins. And all of these things are tied together. So it's a nice cycle and I'm really proud of what the team's been able to deliver and it is part of being able to invest back in the business, such as that advanced research group.

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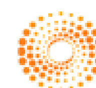

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Andrew Shuler Burns - *D.A. Davidson & Co., Research Division - VP and Senior Research Analyst*

Okay. And I was just -- either Chip or Brian, just wondering on the segment restatement. Looking at the woods, irons and putters versus the former reporting structure, there are a lot. Just trying to get a sense of the moving parts there as we look at the new sales breakdown by category?

Brian P. Lynch - *Callaway Golf Company - Interim CFO, SVP, General Counsel and Secretary*

Jenny, do you have the detail for that?

Jennifer Thomas - *Callaway Golf Company - CAO and VP*

Are you referring to just why we made the changes in our segments or are you asking about...

Andrew Shuler Burns - *D.A. Davidson & Co., Research Division - VP and Senior Research Analyst*

So looking at the 1Q '16 versus -- what was reported in 1Q '16, woods, irons, putters, all up in revenue. What products are shifting where, I guess?

Jennifer Thomas - *Callaway Golf Company - CAO and VP*

Our Gear and Accessories and Other, that's our new segment category, which you see included with our golf clubs category in prior reporting cycles. So we've broken that out from the clubs. There is one piece, which is our package set, which remains in our golf club segment for reporting purposes.

Operator

Your next question comes from the line of Susan Anderson of FBR and Company.

Susan Kay Anderson - *FBR Capital Markets & Co., Research Division - VP of Consumer Research Group and Analyst*

I was wondering if you could maybe touch on just the market again? I think you had mentioned, you guys feel like it continues to be healthier. Is that just mainly driven by cleaner inventory out there? And then all the store rationalization going on. But then also, the stabilization of golf rounds. Is that also helping? And then, how long do you think -- is this sustainable, I guess, over the next like 2, 3, 4, 5 years. And then with that, also, where do you think we're at in terms of the Nike equipment product, that market share kind of being dispersed within the market?

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Okay, Susan. I think you are exactly correct on what we're seeing as positive trends in the marketplace. You're seeing -- there have been market corrections, I guess. A sharp correction in the retail channel over the last year, a significant drop in inventory, there's less OEMs participating in the market, less overall unplanned promotional activity, higher average selling prices, longer life cycles, and it is a more healthy market environment. It's probably a correction that needed to happen. Regarding its sustainability, I think the positive news is a lot of this is structural. So the [do] redoer count reduction is painful, that was to go through. It's a structural change and it would take some time and a great change in sentiment, I think, to reverse that. So I'm optimistic that we will see improved conditions. A lot of my comments regarding this market are forward-looking, though. If you look at market conditions through Q1, the real reality is, they weren't very good. But I feel a lot better about and trying to add color on the outlook, if you would. And I think that's a very relevant point or I wouldn't bring it up. So what was the other part of your question, again?

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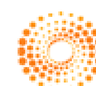

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Susan Kay Anderson - *FBR Capital Markets & Co., Research Division - VP of Consumer Research Group and Analyst*

Where do you think we're at in terms of the Nike share kind of being dispersed throughout the market?

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

I think that there's still some Nike product out there in the field. But it's mostly marked down heavily now and starting to make its way through the channel. I mean, inventories are down so significantly that they don't really come up as a concern at the moment in the field and so I think we are likely pretty far away through that.

Susan Kay Anderson - *FBR Capital Markets & Co., Research Division - VP of Consumer Research Group and Analyst*

Okay, that's helpful. And then I guess just to touch on the ball promotions that you had talked about in the first quarter, is this something that -- I mean, could we see this come back, I guess -- is this category going to get more competitive going forward? Or do you think this is like a one-off thing?

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Susan, I'm not really sure. I saw more promotional environment, which I was -- had some anxiety about, that was delighted that we were able to perform in a strong manner without participating in the promotions and when asked previously, do I see it's improved right now relative to the way it was earlier in the year and whether it could come back or not? It certainly could come back, but I don't have any reason to believe one way or the other at this point. So the market has some share shift particularly to us, vis a vis some of the other smaller players in the marketplace, and it's natural for them to be promotional in response to that and I was encouraged that it didn't have a significant effect on it.

Susan Kay Anderson - *FBR Capital Markets & Co., Research Division - VP of Consumer Research Group and Analyst*

Got it. And then, I guess, last one for me, maybe if you could talk about the areas of the Japan joint venture that's exceeding your expectations. It sounds like apparel's doing really well. Just maybe talk that a little bit more.

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Yes, it's all apparels, Susan. So that joint venture is -- we're barely -- we're 9 months into that now and so -- but it's also a business that we had a close working relationship. They were a licensee of ours for multiple years. Ahead of that, the team's really got their legs under themselves well there now and developing strong product that's resonating in the marketplace through multiple distribution platforms, but it's a 100% apparel focused and outlook remains positive, which I'm confident that venture's going to be a good one for us.

Operator

And there are no further questions. I would now like to turn the call back over to Mr. Chip Brewer for final comments.

Oliver G. Brewer - *Callaway Golf Company - CEO, President and Director*

Thank you, everybody, for dialing in and look forward to talking to you again at the end of next quarter, if not before. Thank you.

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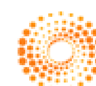

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Operator

This does conclude today's conference call. All participants may now disconnect.

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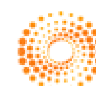

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