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ELY - Q1 2012 Callaway Golf Earnings Conference Call

EVENT DATE/TIME: APRIL 26, 2012 / 9:00PM GMT

OVERVIEW:

ELY reported 1Q12 consolidated net sales of $285m, net income of $32m and fully diluted EPS of $0.37. Expects 1H12 net sales to be $560-575m and EPS to be $0.20-0.25.

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PRESENTATION

Operator

Good afternoon. My name is Allie, and I will be your conference operator today. At this time, I would like to welcome everyone to the Callaway Golf Q1 2012 Earnings Conference Call. (Operator Instructions) I would now like to turn the call over to your host, Mr. Brad Holiday, Chief Financial Officer. Mr. Holiday, you may begin your conference.

Brad Holiday - *Callaway Golf - CFO*

Great, thanks Allie, and welcome everyone to today's call. Joining me today is Chip Brewer, President and CEO of Callaway Golf. During today's conference call, Chip will provide some opening remarks and I will provide an overview of the Company's financial results and we will then open the call for questions. We have also issued today a press release and schedules which provide additional detail concerning our results.

I would like to point out that any comments made about future performance, events prospects or circumstances including statements relating to future investments, growth, profitability and shareholder value, estimated net sales, gross margins, operating expenses, and earnings per share for the first half of 2012, the expected improvement in financial results for the full year of 2012, the estimated impact from the sales of brands and expansion of our apparel license, as well as the Company's estimated capital expenditures and depreciation and amortization expenses 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 certain risks and uncertainties applicable to the Company and its 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, 2011 filed with the SEC together with the Company's other reports subsequently filed with the SEC from time to time.

In addition during the call in order to assist interested parties with period-over-period comparisons, on a consistent and comparable basis, we will provide certain pro forma information as to the Company's performance excluding charges associated with the Company's global operations strategy, non-cash tax adjustments, including a deferred tax valuation allowance charge, restructuring charges, the gain on the sale of three buildings, and the gain on the sale of the Top-Flite and Ben Hogan brands.

We will also provide information on the Company's earnings excluding interest, taxes, depreciation, and amortization expenses, and the intangible asset charges. This pro forma information may include non-GAAP financial measures within the meaning of Regulation G.

The information provided on the call today and the earnings release we issued today include a reconciliation of such non-GAAP financial measures to the most directly comparable financial measures prepared in accordance with GAAP.

The earnings release is available on the Investor Relations section of the Company's website at www.CallawayGolf.com. With that, I'd like to turn the call over to Chip Brewer.

Chip Brewer - *Callaway Golf - President, CEO*

Thanks, Brad. Good afternoon, and thanks everyone for joining our call. I'm glad to be with you today and excited to be part of the Callaway Golf team. I joined Callaway Golf for many reasons. I joined because it's an iconic brand with a history of great product innovation, it's a brand that continues to resonate with passionate golfers, it has a talented team of people who are passionate about the Company and that I'm proud to be a part of, and perhaps most importantly it has tremendous upside potential.

After 13 years at Adams Golf, 10 as its CEO where we successfully turned around and profitably grew that business, I believe I bring a certain amount of industry expertise, especially in the areas of marketing, product innovation, and team building; and I know I have a strong passion for the business and the game.

I believe the combination of all of the above will mix well and create significant opportunity for all involved. To be sure, this is a dream job and an unbelievable opportunity for me.

The team and I here intend to regain momentum in the marketplace and to create shareholder value. Looking at our results for the first quarter, we were improved relative to last year, and we are forecasting continued growth and improvement through the balance of the year.

Furthermore, we are pleased with several recent product launches, especially the RAZR Fit Driver, which was named Editor's Pick by Golf Digest Hot List, and the Hex Black Tour and Chrome golf balls, both of which have unique technology and performance benefits. We are also optimistic about our recent launch of the Metal-X putters which although just recently launched, are off to a great start.

On the tour front in Europe, 23-year-old Brandon Grace is on fire with three wins already this year. In the US, Phil Mickelson is continuing to thrill us with his charismatic play, and across the globe our products continue to perform well in the bags of staff and non-staff players alike.

However, the rate and pace of improvement is not consistent with expectations or our previous guidance. Thus, while we continue to believe strongly in the opportunity and that our strategic path towards simplification and focus is correct, we know there's a lot more work to do and that further changes will be needed to make sure our efforts are effective.

At this point in my tenure, I don't have all the answers and I'm not prepared to roll out a master plan. However, I do want to reiterate my belief in the strategy for simplifying and focusing our business. I believe shareholders can take heart in the fact that this is well under way. For instance, as initiated under Tony's leadership, we have made good progress on some big issues such as the global cost reduction restructuring that occurred last summer, the sale of the Top-Flite and Ben Hogan brands, the comprehensive settlement agreement with Acushnet, and the comprehensive licensing agreement with Perry Ellis International, which will simplify our North American model while benefiting from brand-enhancing apparel in the marketplace.

Going forward, you can expect further efforts towards simplification and focus as I am convinced that first and foremost we need to regain momentum in our core brands, the Callaway and Odyssey brands, and our core products, golf clubs and golf balls.

You can also expect us to continue our previously-stated strategy of increasing our investment in demand creation activities such as tour and marketing. We will do this while continuing to evaluate either taking costs out of the business or re-focusing expenditures to demand creation activities, all with an eye towards long-term sustained profitability.

The previously-mentioned simplification initiatives are one example of how we will achieve these cost savings and investment goals simultaneously. Lastly, but importantly, again although I've been here just a few weeks now, the team and I have already started to make what I believe are important changes to make us more effective in the marketplace. These include streamlining the organization, refocusing the market strategy on specific core fundamentals of the avid golfer, and re-energizing the product strategy to be both more aggressive and consistently on trend.

Having said this, let me also take a moment to say how impressed I am with the R&D resources and team here. We intend to make our products team and platform a real engine for growth going forward.

The changes I'm mentioning are just getting started and there's a lot more to be done, but the opportunity's fantastic and we have a great base to work from, and we remain confident in our ability to be successful. I look forward to updating you on the progress along the way and am delighted to have the opportunity to serve both Callaway Golf and our shareholders. Brad, over to you.

Brad Holiday - *Callaway Golf - CFO*

Thanks, Chip. I will quickly cover some of the highlights for the first quarter and then we'll open the call for questions.

Consolidated net sales for the quarter were $285 million with net income of $32 million or fully diluted earnings per share of $0.37 on 84.9 million shares. These results compared to 2011 results of $286 million in net sales, net income of $13 million and fully diluted earnings per share of $0.15, on 84.7 million shares.

Included in the 2012 results are a positive non-cash tax adjustment of $0.14 associated with the deferred tax asset allowance requirement, and a gain on the sale of the Top-Flite and Ben Hogan assets of $0.05. Included in the 2011 reported results were charges associated with our global operations strategy related to the opening of our new manufacturing facility in Mexico of $0.05, offset by a gain on the sale of some buildings located here in California of $0.05.

Excluding these adjustments, 2012 pro forma earnings per share were $0.18 in line with our internal expectations for the quarter and compared to $0.15 last year.

Overall sales, while flat compared to last year, were positively impacted by an additional driver launch during the quarter, positive Japan sales comps, and strong sales of our RAZR Fit Driver and new Callaway Premium Golf Balls. Offsetting these positive factors were lower iron sales, the planned timing shift of new Asia products that are scheduled to launch during the third quarter this year compared to the first quarter last year, as well as the launch timing of our new Odyssey Metal-X Putter, which launched during the second quarter of 2012.

In looking at our regional breakout, US sales increased 3% to $150 million compared to $145 million last year and represents 53% of total company sales. International sales for the quarter were $135 million, a decline of 3% compared to last year's sales of $140 million. This decline was due to lower sales in Europe and rest of Asia, partially offset by a 12% increase in Japan sales.

The increase in Japan sales was due to a lower sales comp last year because of the earthquake, partially offset by the planned shift in the launch of timing of the Legacy line of products from the first to the third quarter. Foreign currency changes had very little impact on year-over-year comparisons.

For our product categories, Woods sales increased 1% to $91 million compared to $81 million in 2011. As mentioned earlier, this increase was due to strong sales of our RAZR Fit driver, as well as the first quarter launch of the RAZR Black line of woods compared to the Octane line of woods that was launched during the fourth quarter of 2010.

Partially offsetting these increases were the planned delay of the Asia line of products to the third quarter, and the lower retail price of the RAZR Black driver at $249 compared to the Octane driver at $299.

Irons sales declined 17% to $58 million compared to $70 million last year, due to lower sales of our new irons compared to the successful launch of the RAZR-X irons last year.

Putters sales declined 16% to $24 million compared to $29 million last year, due to the timing of the launch of our new Metal-X line of putters that were launched during the second quarter rather than the first quarter last year.

Golf ball sales declined 5% to $43 million compared to $45 million last year, due to lower Top-Flite sales, offset somewhat by strong sales of Callaway golf balls, in particular our new Premium Hex Black Tour and Chrome golf balls.

Accessories and other sales increased 13% to $69 million, compared to $61 million last year due to increases in packaged club sets and apparel.

First quarter gross margins were 44% of net sales compared to 43% last year. Included in last year's gross margins were pre-tax charges of $6 million associated with our Mexico manufacturing initiative. Excluding these charges, 2011 gross margins were 46%.

Gross margins were in line with our expectations for the quarter and were adversely impacted this year due to higher technology costs in the RAZR Fit product line, the lower retail price on the new RAZR Black driver as compared to the Octane driver, the planned shift in launch timing of the Asia line of clubs to the third quarter, and closeout activity in the putter category in anticipation of the second quarter launch of the new Metal-X line of putters. These adverse factors were partially offset by lower club assembly costs associated with our new manufacturing facility located in Mexico, as well as higher gross margins on Callaway Premium Golf Balls.

Operating expenses were $97 million compared to $101 million last year. Included in this year's results is a gain of $7 million associated with the sale of Top-Flite and Ben Hogan, while last year included a gain of $6 million associated with the sale of three buildings within our corporate campus here in Carlsbad. The overall OpEx savings from last year's cost reductions were approximately $9 million for the quarter, in line with expectations, and were partially offset by incremental demand creation spending and general inflation.

Other income was $4 million compared to expense last year of $1 million, due to gains on foreign currency contracts.

Looking at the balance sheet, we ended the quarter with $52 million in cash and $86 million outstanding on our credit facility. Consolidated net receivables were $255 million, compared to $267 million last year and DSOs improved to 82 days compared to 85 days last year. The overall quality of our accounts receivable remain good.

Net inventories were $236 million compared to $258 million in 2011. As a percent of trailing 12-month sales, 2012 inventory improved to 26.7% compared to 27.1% last year. Capital expenditures for the quarter were $9 million compared to $7 million in 2011. We estimate full-year CapEx of $25 million to $30 million. Depreciation-amortization expense was $9 million for the quarter compared to $10 million last year, and we estimate full-year depreciation and amortization of $35 million to $40 million.

Before I get into the business outlook, I want to provide some details about the recent sale of the Top-Flite and Ben Hogan assets as well as the restructuring of the Perry Ellis North American Licensing Agreement, both of which support our goal of streamlining and simplifying our business model.

The Top-Flite and Ben Hogan sale include the global branding rights with a limited transition period. As mentioned earlier, we recognized a $6.6 million gain on the sale during the quarter. The new apparel license transitions sales from direct golf channels in the United States and Canada which we previously handled internally, to a licensed model that will now be handled by Perry Ellis who currently services department stores and other non-golf channels. This will result in lower net sales, increased royalty revenues over time, and lower operating expenses.

To give you a little color on the size of these combined businesses, annual net sales in 2011 were approximately $70 million. Gross margins were approximately $13 million with a slight operating loss. Annual cost savings resulting from the sale and new license agreement are estimated at $9 million with a one-time charge of approximately $2 million to get these savings. The impact on 2012 is estimated to be a reduction in net sales of approximately $10 million, and a reduction in operating income of approximately $10 million, which includes the one-time charges of $2 million.

About half of this reduction in operating income or $5 million is expected to adversely affect the first half results.

So, with that as a background, along with the slower pace of recovery that Chip mentioned earlier, we are adjusting our first half guidance as follows.

Net sales for the first half of 2012 are estimated to be $560 million to $575 million, compared to prior guidance of $610 million to $630 million, and $559 million last year. Gross margins for the first half are estimated to be at 43% compared to prior guidance of 44%, and flat compared to last year.

Operating expenses for the first half are estimated to be $214 million, the same as prior guidance and slightly higher when compared to $209 million last year. This estimate includes savings from the cost reduction initiatives taken last summer, offset by the one-time expenses relating to the simplification initiatives I just mentioned and an increase in demand creation spending, a majority of which falls into the first half.

Earnings per share is estimated at $0.20 to $0.25, compared to prior guidance of $0.40 to $0.45, and an increase compared to $0.15 last year, and assumes shares outstanding of 64.5 million shares and the after-tax impact of the outstanding preferred equity.

As mentioned in our press release, this forecast excludes the $6.6 million gain on the sale of Top-Flite and Ben Hogan, and assumes for comparison purposes a 38.5% tax rate. 2011 results exclude charges associated with the Company's global operations strategy, impairment of assets, non-cash tax adjustments, restructuring, and the gain on the sales of buildings. Additionally while we do expect a significant improvement in our financials compared to last year, both on a GAAP and pro forma basis, given the impact of the initiatives I just covered, and additional initiatives that are currently under way, we are suspending annual guidance at this time.

We will address our full-year guidance later this year as we complete these initiatives and can better assess their impact. We would now like to open the call for questions.

QUESTIONS AND ANSWERS

Operator

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

Scott Hamann - *KeyBanc Capital Markets - Analyst*

Hey, good afternoon, guys. Chip, welcome aboard.

Chip Brewer - *Callaway Golf - President, CEO*

Thank you, Scott. Good to be here.

Scott Hamann - *KeyBanc Capital Markets - Analyst*

So, a couple questions, here. Number one, Brad, just in terms of the numbers you gave us, was that just for the Perry Ellis deal, or was that including the Top-Flite and Hogan stuff as well?

Brad Holiday - *Callaway Golf - CFO*

It was inclusive of all of them, Scott.

Scott Hamann - *KeyBanc Capital Markets - Analyst*

Okay, perfect, and then just kind of stepping back, can you give us the lay of the land currently at retail? What's some of the equipment stuff doing, in terms of retail, what are you guys doing in terms of retail, and what's going on there?

Chip Brewer - *Callaway Golf - President, CEO*

Okay. Sure, Scott, this is Chip. Your questions are primarily focused on the US market, I assume, so I'll respond along that line and then you guide me from there. The market conditions in the US are much improved over the last few years so the markets are up, sell-through has been relatively strong this year, our business has been strong in the driver category, led by RAZR Fit, but overall our driver business is very good. The golf ball, the premium golf ball business has been very good for us as well, and we've been weak in the iron category and the fairway wood category specifically. I think if you're following the market, you'll know what the fairway wood issue is a specific competitive issue.

So, market's up. We've got some nice strong points, and we have some areas where we need to have some work to do.

Scott Hamann - *KeyBanc Capital Markets - Analyst*

Okay, and then just in terms of the marketing, the demand creation initiatives, I see a lot of stuff on TV and in print. Do you feel like you're getting some good reception on that, or are there some tweaks you need to make, or how should we think about that unfolding here?

Chip Brewer - *Callaway Golf - President, CEO*

I think it's both, Scott. You know, they've done some excellent work with the marketing side, obviously. We're spending a significant amount of incremental money in the area and that makes perfect sense. We're going to continue with that, and yet, I also believe there are some areas where we have to look at the effectiveness of that marketing and make some tweaks. So, we're in the process of that right now.

Scott Hamann - *KeyBanc Capital Markets - Analyst*

Do you feel that the competitive set has also kind of stepped it up in terms of their marketing spend to combat this?

Chip Brewer - *Callaway Golf - President, CEO*

That's a good question. In terms of marketing spend, you know, I don't really have a feel whether they have spent significantly more or not. I don't think we have a spend issue at Callaway. I think we're spending adequately, and I like a lot of what we're doing, and in other areas I'm working with the team now and we're going to make some changes which I think will have improved effectiveness going forward.

On the organizational side, the marketing group now reports directly to me and that's one of the changes that was recently instituted. So, like a lot of it, love the strategy, love the potential, and in overall effectiveness we're got a little bit of tweaking to do but also some positives.

Scott Hamann - *KeyBanc Capital Markets - Analyst*

Okay great, thanks a lot, guys.

Operator

Your next question comes from James Hardiman with Longbow Research.

James Hardiman - *Longbow Research - Analyst*

Hi, good afternoon. Thanks for taking my questions. Chip, welcome aboard.

Chip Brewer - *Callaway Golf - President, CEO*

James.

James Hardiman - *Longbow Research - Analyst*

Just big picture here Chip, I mean obviously, I don't expect you to come in and throw anybody under the bus or cast any aspersions, but I think the investment community is starting to put their finger on what has prevented this company from ultimately reaching its potential. Obviously you don't have a silver bullet, but as I think about I guess two things. One, some of the recent moves that you guys have made, you keep talking about this idea of focus, focus, focus. Is that an indication that maybe the focus has not been there, and I guess conversely, can you talk a little bit about your experience at Adams, which has obviously had a much better go of it at least from a stock performance over the last couple years?

But ultimately, the question here is, is it that difficult to make money in this industry or have there been some unforced errors along the way?

Chip Brewer - *Callaway Golf - President, CEO*

I think in all fairness, there have been some unforced errors, and I like this industry, and I'm optimistic about our potential in it. Candidly, if we could gain market share at Adams, and make money at Adams, the resources here, it's a much better place to start from. Let's talk just candidly on that. The potential is outstanding.

One of the key strategic elements that we're all aligned on now is simplifying and focusing the business. That isn't a strategy that I brought to Callaway. The team here and Tony Thornley, who preceded me, were already under way with that strategy. It makes all the sense in the world.

We're going to continue with that, and then from there, we're going to look at some further streamlining on the organizational front, we're going to work on the marketing effectiveness and the product strategy, to deliver the momentum in the marketplace that then leads to profitability and we've got the fundamentals here. We have one of the best brands in the history of the sport, the consumer loves this brand, we've got the resources in this organization, I'm exceptionally impressed with the R&D resources here and capabilities that is going to be a lot of fun, engaging with them to really make the product side of the business a competitive weapon in the marketplace. We're optimistic but it is some fundamentals and obviously for whatever reason, we haven't performed up to expectations.

So, hence me being here, and you know, the team and I having a pretty good opportunity from here forward.

James Hardiman - *Longbow Research - Analyst*

Very helpful, and then just secondly, I was hoping whether it be Brad or Chip, if we could just have a quick conversation on Top-Flite. I guess the ball business more generally. From the beginning, the Top-Flite asset was really seen as more of an operational asset than a brand asset, given the Chicopee operations. I'm assuming you still have all the operations that you acquired with Top-Flite, but the rationale used to be that you needed the incremental volumes from the Top-Flite balls to gain the leverage you need to make significant profits in the ball business. Is that no longer the case, and do you think that you're going to now take what was previously a high-low strategy with Callaway and Top-Flite and maybe bring or extend that Callaway brand where it's previously not been?

Chip Brewer - *Callaway Golf - President, CEO*

I'll take parts of it. Brad, you feel free to jump in here, particularly on the historical perspective. The golf ball business is one of the businesses that I'm most excited about here to start with. It hasn't been profitable, historically, here at Callaway. They certainly had a high-low strategy. That is not our strategy going forward. We're not going to take the Callaway brand down.

The fundamental thing that we need to make money in golf balls is a golf ball that people want to play and buy, and I think we have that right now. The technology platform and the performance of the Hex Black Tour and the Hex Chrome are outstanding, and they have a clear difference in the marketplace both from the aerodynamics and the spin separation and the overall performance of the product. There's no weaknesses now.

So, as you're starting to see us gain market share in that premium category, as we continue to do that, we're going to be able to pull the right levers to deliver profitability in the category but first and foremost, the main fundamental issue is that product performance and a product that people want to play, and I'm exceptionally excited about that because we've got that part of it under way.

A lot of hard work to do to keep that going, a lot of good competition, but you know, the most important building block of it is under way and that value side of the ball business, that is a strategically incredibly difficult business. You're always under cost pressure, you can't reinvest back in it, and it essentially was a business that it was eroding over time without a clear strategic path to revive it.

So, we do have all the same operations that none of the operations went with the sale. It will focus our business. We still do have some work to do here, but the biggest and most important thing is, in the premium ball category we've got a differentiated product that people are starting to really appreciate, and I think we're going to be able to work with that and deliver a profitable ball business.

Brad Holiday - *Callaway Golf - CFO*

James, I would just add maybe a couple things. You know, from the time when we bought them originally, there was this kind of a high-low strategy with mass and sporting goods as king of a target for the (technical difficulty). A lot's changed in that marketplace where a lot of more premium brands were started to really move their balls in there, so the competition became different at retail.

So, it has changed. Through the years we've tried to manage the cost side of it by using third parties for the lower technology golf balls, but don't forget we also acquired all the product patent portfolios with Top-Flite which has allowed us to make the kind of balls we're making today in the premium segment. So, a lot has changed, and I think to Chip's point there's a lot more work to be done but I think that we're starting to see some nice signs around the premium golf balls this year, and I like Chip am excited that I think we've got some great products out there, and Top-Flite -- obviously the sale of it was, will take a lot of different initiatives off our plate and allow us to focus on our two core brands of Callaway and Odyssey. So, I think moving forward you'll see a lot more focus against those key brands.

James Hardiman - *Longbow Research - Analyst*

Excellent. Thanks guys, and good luck on the rest of the year.

Chip Brewer - *Callaway Golf - President, CEO*

Thanks, James.

Operator

Your next question comes from Dan Wewer with Raymond James.

Dan Wewer - *Raymond James & Associates - Analyst*

Thanks. Chip, you've talked about focusing and narrowing on golf balls and golf clubs. I guess you're perhaps suggesting that golf shoes and uPro probably doesn't have a long term potential for Callaway, but besides footwear and uPro, is there anything else that doesn't fit with this narrowed focus that you're alluding to?

Chip Brewer - *Callaway Golf - President, CEO*

Yes, let me talk about footwear and uPro, since you brought those up. Those clearly are not in the two key categories that I'm most focused on, so that's a very fair assessment, but no decision's been made on those at this point. You know, the long and short of it is, they're going to have to sing for their supper and show us clear path to where there's profitability there.

So, we will evaluate those appropriately, but there is not a decision that has been made on those products right at this point. The -- and then other than those, no, I don't think there's much else that falls outside of that focus element for us.

Dan Wewer - *Raymond James & Associates - Analyst*

A second question I had, Adams as you alluded to had limited resources, particularly in marketing, yet I was always amazed at how much buzz that Adams could create in the marketplace. Can you give us your thoughts as to the direction that Callaway has made in marketing? I guess one obvious difference between Adams and Callaway is that Adams had a much bigger focus on the performance of the technology, of their equipment, and maybe a little bit less show biz, that Callaway has used in its marketing in the last few years.

Chip Brewer - *Callaway Golf - President, CEO*

I think that might be a fair statement, and I think that the -- we are going to focus the marketing at Callaway a little bit more towards some proven desires of the avid golfer, so we're going to re-look at some of the things we've done. The market they've done has created great awareness, it's achieved many of the objectives, but I will be candid. I think we can do better and we will be doing better soon. You'll see some advertising coming out over the next few weeks that the team and I have already tweaked where we would have had family of irons in the ads, without calling out any specific iron individually, and without clarifying any specific benefit of the iron. The advertisements you'll see here in the near future will be a singular focus on a product, and that product's benefit to the consumer.

So, based on my experience, I think that'll be more impactful.

Dan Wewer - *Raymond James & Associates - Analyst*

And then I guess the last question I had, regards R&D or technology and obviously the Callaway product line this year arguably is the best it's been in a decade. I was curious, do you sense any reason to change the direction on R&D, or rather, do you think it's just an issue of adjusting the marketing message and obviously TaylorMade's been amazing with their marketing programs the last few years. Is that really the key driver, as to that would make a difference?

Chip Brewer - *Callaway Golf - President, CEO*

I think it's a little of both, Dan. I think that I like you, am extremely impressed with the Callaway products, their performance and our resources there. But, I also expect us to be more aggressive on the product side as well, and we'll push a little bit harder there, we'll take a little more risk at [times and lead], and also we need to be, make sure that we're consistently on-trend at those points where we're not leading.

So, I've got some high expectations for what this team can do and I've been very impressed with my exposure to them. I think they're going to be up for that challenge and we're going to end up using that as a competitive weapon in the marketplace.

Dan Wewer - *Raymond James & Associates - Analyst*

Okay great, thank you.

Operator

Your next question comes from Casey Alexander with Gilford Securities.

Casey Alexander - *Gilford Securities - Analyst*

Hi, good afternoon, Chip, good afternoon, Brad. One of the little surprises here was the putter business, especially given the fact that most of the world thought that there was going to be a stronger market for putters, particularly the long and belly putters. What's happening with the long and belly putters, how does that tie into Metal-X and if so, is that tied to Metal-X and still a second quarter story?

Chip Brewer - *Callaway Golf - President, CEO*

It's a second quarter story, Casey, because the Metal-X didn't ship until the second quarter and I think even the bellys and mids are just getting out now. But, the belly and mid has leveled out a little bit more in the marketplace than what we had initially expected it to. It had a nice surge last year, at the end of the year, and it has leveled off at that point but hasn't continued to build. So, it's definitely up, but pending on what the expectation for that would have been, it hasn't -- if you look at a product as an S curve, it's at the top of the S curve and level now, not continuing to build in momentum.

Casey Alexander - *Gilford Securities - Analyst*

And the R&D side, with the narrowing the focus of the business down to Callaway clubs and balls, was there incremental marketing or R&D money that was being spent in any of the other areas, apparel, Top-Flite, that can allow you to shave some dollars off the R&D budget?

Chip Brewer - *Callaway Golf - President, CEO*

Brad, go ahead, do you have a thought on that?

Brad Holiday - *Callaway Golf - CFO*

Yeah, I mean most of it is targeted towards clubs and balls, obviously, but -- and putters. There was some money obviously spent Casey on GPS devices, and I think as --

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Chip Brewer - *Callaway Golf - President, CEO*

Currently we have, no changes have been made on that.

Brad Holiday - *Callaway Golf - CFO*

Yeah, no changes, and I think as Chip pointed out, I think there are still things under evaluation and as he said, they're going to have to think for their supper. So, we're still going through a lot of evaluations of different things with a focus on continuing to try to simplify even internal process of how we operate, but really providing the focus towards clubs and balls. So, I would say that there are probably a few more changes to come, but right now no changes have been made from where we were operating.

Casey Alexander - *Gilford Securities - Analyst*

Talk about the plan of the timing of shipments to rest of Asia, and also Legacy of Japan shifting from first quarter to third quarter. Is that, you know, part and parcel of what Tony talked about last quarter, maybe the quarter before, about trying to time product introductions to the right, you know, sort of right cycle in the markets? And as a result of that, should we be looking for something, for a decent improvement in those markets in the third quarter of this year?

Chip Brewer - *Callaway Golf - President, CEO*

As it specifically relates to Japan, yes, on all fronts, Casey. They separated what they call the global products, which is the RAZR Fit and RAZR X Black product, and launched those in the first quarter along with the rest of the world. They would've previously, in previous years, launched Legacy at the same time, which is a awful lot to focus on at the same time. This year, they're moving that Legacy line, which is a primary launch for them, into the second half of the year and it'll give it its own time and I think it makes a lot of sense. So, I applaud Alex and his team over there for that decision, and we're excited about that.

It will give them upside versus the second half last year, but also they're gaining the benefit of comparison against the time period where the economic environment was naturally very depressed over there after the tsunami.

Casey Alexander - *Gilford Securities - Analyst*

Well, given sort of the unique margin profile of the Japanese market, shouldn't that improve the overall blended gross margin of the entire enterprise for the third quarter as well?

Chip Brewer - *Callaway Golf - President, CEO*

Absolutely.

Brad Holiday - *Callaway Golf - CFO*

That's right, Casey.

Casey Alexander - *Gilford Securities - Analyst*

Okay. More to the rationalization of the product lines, due to that simplification, is there more cost saving opportunities in the business that might take more time such as I would assume that you're eliminating some front-end marketing teams, you might be freeing up some office space that might allow you to again tighten down the business and reduce some costs, so there's still some opportunities like that out there?

Chip Brewer - *Callaway Golf - President, CEO*

Casey, we're not really prepared to make any decisions at this point on that, but yes, there's got to be more opportunities as we look at streamlining the business, and some of those will be realigned into demand creation activities and some might be, flow to the bottom line as we move forward. So, we'll be looking at each and every one of those opportunities as the team and I get further into my tenure here.

Casey Alexander - *Gilford Securities - Analyst*

Well, you might not be prepared to answer it, but I'm prepared to ask it, that's for sure.

Chip Brewer - *Callaway Golf - President, CEO*

Casey, that much I know is true.

Casey Alexander - *Gilford Securities - Analyst*

Let me ask you one more question. The Top-Flite ball business, my understanding, and correct me if I'm wrong, because I could very well be wrong, but I thought that perhaps Dick's has sort of an option as to whether or not to have you continue to produce the Top-Flite balls for them? Have they exercised that option or given you any indication as to what they're going to do, and do you have some sort of an idea how that's going to work out?

Brad Holiday - *Callaway Golf - CFO*

This is Brad, Casey. I say no comment. I mean, obviously during the discussions, that was tossed around but that's really up to them and if they wanted to come back, why certainly we would be happy to talk to them but that's their decision, and there haven't really been any further discussions at this point in time.

Casey Alexander - *Gilford Securities - Analyst*

Okay, all right. Thank you very much.

Chip Brewer - *Callaway Golf - President, CEO*

Thanks, Casey.

Operator

Your next question comes from Craig Kennison with Robert W. Baird.

Craig Kennison - *Robert W. Baird & Co. - Analyst*

Good afternoon. Look forward to working with you, Chip. First question here, many of mine have been asked and answered, but I think observers of this industry will note significant consolidation over the years, and really a rise in power of some of the larger sporting good brands. I think even your prior firm decided to join a larger team. Could you just talk about maybe the advantages and disadvantages of being a standalone golf company today?

Chip Brewer - *Callaway Golf - President, CEO*

I guess hypothetically, I can, yes. There's certainly been consolidation through the golf industry, both on the OEM side and on the retail side. The advantage of standalone is provided that you have scale, the focus and purity of that play. Some of our competitors don't have that same advantage and I know from conversations that they suffer from that. But, there's also public company expense, and other potential incremental costs that come from being a standalone entity. Once you reach enough scale, I mean, I was at Adams for 13 years as a standalone public company, and despite scale we were able to grow market share, and deliver consistent profitability. So, very achievable, and a situation that I'm very comfortable with. Callaway has significantly more resources and scale, so I think I'm a fan of that pure play, but I can certainly argue both sides of it.

Craig Kennison - *Robert W. Baird & Co. - Analyst*

Thank you for that, and then certainly I understand you're not yet in a position to lay out the full strategy and the financial goals you may set, but I'd be interested in how you plan to create shareholder value and what type of targets you would plan to set, whether it's a focus on returns, or growth, or market share, or margin, what -- although without giving me numbers, what are the basic buckets?

Chip Brewer - *Callaway Golf - President, CEO*

Sure, sure Craig. Not a problem. You know, at this point I can't give you any specific metrics for multiple reasons. One, because we provided all the guidance that we were able to provide at this point, and secondly because I'm still trying to figure all that out.

I believe that we have two primary objectives, though. One is to grow market share and restore the momentum of the brand, and the second is to restore profitability. I believe we'll achieve both of those, at the same time.

Craig Kennison - *Robert W. Baird & Co. - Analyst*

And finally, what's a reasonable timeline to expect that sort of plan in more detail?

Chip Brewer - *Callaway Golf - President, CEO*

You know, that's a good question. I think that certainly later this year, we should be able to give you more color on that and more detail. Brad, does that seem reasonable?

Brad Holiday - *Callaway Golf - CFO*

I think so. I think that's reasonable.

Chip Brewer - *Callaway Golf - President, CEO*

Does that seem reasonable, Craig?

Craig Kennison - *Robert W. Baird & Co. - Analyst*

That would be great. I look forward to it, and good luck.

Chip Brewer - *Callaway Golf - President, CEO*

Thanks, I appreciate it.

Brad Holiday - *Callaway Golf - CFO*

Thanks, Craig.

Operator

Your next question comes from the line of Stefan Mykytiuk with Pike Place Capital.

Stefan Mykytiuk - *Pike Place Capital - Analyst*

Yeah, hi, good evening. A couple questions. Brad, you said, I think you said the business, the Top-Flite business and the Perry Ellis license and Ben Hogan were $70 million in revenues, $13 million of gross profit, and a small operating loss in 2011?

Brad Holiday - *Callaway Golf - CFO*

In 2011, that's correct.

Stefan Mykytiuk - *Pike Place Capital - Analyst*

Okay, and then what I didn't get is, I think you said in 2012 the impact of those will be a $10 million decline in revenues and a $10 million decline in operating income?

Brad Holiday - *Callaway Golf - CFO*

That's correct.

Stefan Mykytiuk - *Pike Place Capital - Analyst*

Okay. So, how do we get from $70 million in revenues last year only you know, basically being divested, and that's only causing a $10 million revenue decline this year, and then how do we go from getting rid of a business that was losing some money to now all of a sudden have a $10 million hit in operating income?

Brad Holiday - *Callaway Golf - CFO*

Sure. The full year, I tried to give you that just to give you an idea of scale of what it was, but we have been selling Top-Flite balls through the first half of this year, and so we will now be going into the wind-down stage where we will be selling our excess inventory and same with Perry Ellis, that kind of goes through the August-September time frame. So, we have expense associated, and then we will be winding down and eliminating any excess inventory, obviously not at full margins, plus there will be some one-time expenses as we reduce the organization to get at the $9 million worth of savings I talked about.

So, what I was trying to do is give you kind of full year what it looked like, but then the impact has a lot to do with timing of how we wind these businesses down going into next year.

Stefan Mykytiuk - *Pike Place Capital - Analyst*

Okay, but the $10 million of operating income hit is partially one-time expenses? How much of that in 2012 is one time versus?

Brad Holiday - *Callaway Golf - CFO*

$2 million. $2 million is what is one-time expenses associated with I'd call it just reducing the expense, restructuring, etc., is about $2 million for this year.

Stefan Mykytiuk - *Pike Place Capital - Analyst*

Okay, and $8 million, the other $8 million is because you're winding -- you're selling this inventory and getting out of the business, or is it because there's a loss of scale?

Brad Holiday - *Callaway Golf - CFO*

It's really the wind-down. We're going to lose $10 million and the margins on that are, you would normally expect it to be maybe half of that, but because we're really selling and liquidating inventory over the balance of the year, our margins will be a lot less as we liquidate. So, it's just got a higher impact on the lost sales of $10 million.

Stefan Mykytiuk - *Pike Place Capital - Analyst*

Okay, so -- and I know it's a ways out there, but as we look into 2013, that -- does that go back to being a wash, then, essentially versus 2011?

Brad Holiday - *Callaway Golf - CFO*

Yes. If you think about it, when you take a look at '11, we had gross margins of about $13 million of which we're going to save about $9 million in structure. Now, not included in that is we will pick up some additional royalty revenues, and the goal would be to replace some of those sales and so we would hope to be break-even or better than we were in 2011 with the impact on the business. Not only does it provide us a more focused business and less distractions, but it should be a bottom-line lift to the Company.

Chip Brewer - *Callaway Golf - President, CEO*

Yes.

Stefan Mykytiuk - *Pike Place Capital - Analyst*

Okay. So. Okay. I mean, you know, perhaps I'm being generous but the way I'd look at it is, the whole $10 million is in effect one time because you're getting out of these businesses, and therefore we're not going to have that drag going forward.

Brad Holiday - *Callaway Golf - CFO*

That's fair. You can class it as that, I was just trying to say that we will be liquidating, so you could call it a one-time. One-time to me is actually taking structure out, that's how I took it. That's how I looked at it, okay?

Stefan Mykytiuk - *Pike Place Capital - Analyst*

Okay. And then secondly, I guess for the -- for Q2, the putters, because you're doing the launch then should we expect the putter business to improve sequentially from Q1 because of that launch and then perhaps there's a chance that those compares actually are better year-over-year as opposed to being down?

Brad Holiday - *Callaway Golf - CFO*

Oh, yeah. Putters is all about timing, launch timing, and since we launched in Q2 now, the comps on putter should be better than they were last year. Or compared to last year.

Stefan Mykytiuk - *Pike Place Capital - Analyst*

Okay.

Brad Holiday - *Callaway Golf - CFO*

I think that was your question, right?

Chip Brewer - *Callaway Golf - President, CEO*

He was comparing to Q1, but it's --

Brad Holiday - *Callaway Golf - CFO*

Oh, Q1. Oh, it'll be --

Chip Brewer - *Callaway Golf - President, CEO*

They're going to be better.

Brad Holiday - *Callaway Golf - CFO*

Yes, it'll be better, in both cases.

Stefan Mykytiuk - *Pike Place Capital - Analyst*

Okay.

Chip Brewer - *Callaway Golf - President, CEO*

And our market shares in putters look good through the first quarter as well, so the brand there's strong, the product's being received well, and putter franchise looks like it's in good position.

Stefan Mykytiuk - *Pike Place Capital - Analyst*

Okay, and lastly the irons down in the first quarter, it sounds like what you're saying is the last year you actually had a pretty good launch and this year they're just not going as well as planned, or what was the -- what's the story in irons?

Chip Brewer - *Callaway Golf - President, CEO*

You got it. We're not doing as well in the iron category as we did last year, and as we expect to do in the future.

Stefan Mykytiuk - *Pike Place Capital - Analyst*

Okay, and on the drivers I guess there's still a chance that Q2, you know, that product's doing well but my understanding is the reorders really come in May and June, and some time in the summer so there's a chance where you know, if the product is a hit, there's still upside from those going forward?

Brad Holiday - *Callaway Golf - CFO*

Yes, we're pleased with our driver business this year and regaining share.

Stefan Mykytiuk - *Pike Place Capital - Analyst*

Okay, terrific. Thanks very much.

Brad Holiday - *Callaway Golf - CFO*

You're welcome.

Operator

And your final question comes from the line of Rommel Dionisio with Wedbush Securities.

Rommel Dionisio - *Wedbush Securities - Analyst*

Thanks, good afternoon. You know, in prior conference calls over the last few years you guys have alluded to the woods segment seeing some negative trade-down effect in a tough economy. I wonder if just with a slight improvement in the market, are you guys seeing some reversal there?

Obviously you're seeing the RAZR Fit is a really solid introduction gaining share, but are you seeing consumers flock back to the $399 price point, in drivers?

Chip Brewer - *Callaway Golf - President, CEO*

Yes. They really are. It's one of the exciting aspects of the business and the industry is that the consumer is paying for technology and performance, and you see that in the $399 price point in drivers and in some other areas. So, absolutely.

Brad Holiday - *Callaway Golf - CFO*

And we saw that trend actually start last year, as we were coming out of the economic recovery that we actually saw a bigger shift towards the $399 drivers than the $299, so I think this is a continuation of that trend.

Chip Brewer - *Callaway Golf - President, CEO*

Yeah, and it's not --

Brad Holiday - *Callaway Golf - CFO*

It's encouraging.

Chip Brewer - *Callaway Golf - President, CEO*

It's not specifically drivers, either.

Rommel Dionisio - *Wedbush Securities - Analyst*

Okay, one quick follow up if I could. Chip, I know you're not outlining your entire strategic plan right off the bat here, but when you guys say simplification, I understand there are non-core businesses and units and so forth, but when you look at the core Callaway woods, irons, putters, is SKU proliferation, would that fall under this realm of simplification? I mean, you have different units, different SKUs that you sell in Japan, so in the US and so forth, is that something you would look to address? Or, are you fine with sort of the core Callaway business lines for now?

Chip Brewer - *Callaway Golf - President, CEO*

You know, it could be, although I don't really at this point see a SKU proliferation issue. But, if we get further into this and we see that, it would certainly fall into that category. So, but Rommel, I would tell you that just getting rid of these two brands, Top-Flite and the Perry Ellis apparel side, reduces SKUs a lot so when we talk about simplification it simplifies our order management, our warehousing, etc., so just the divestitures of those business and the new model just makes the rest of our business a lot easier to handle.

Rommel Dionisio - *Wedbush Securities - Analyst*

Great, well thanks very much, gentlemen.

Chip Brewer - *Callaway Golf - President, CEO*

Thank you.

Operator

There are no further questions. At this time, I would now like to hand back over to Mr. Chip Brewer, CEO, for any closing remarks.

Chip Brewer - *Callaway Golf - President, CEO*

Thank you, Allie. I just want to thank everybody for calling in. We really appreciate your time and attention today. We're excited about the future prospects of this business, and we look forward to continuing to communicate with you as we work through the rest of this improvement effort, and look forward to talking to you end of second quarter. Thanks for calling.

Operator

Thank you for participating in today's conference call. You may now disconnect.
