

# Mossberg's Investor Digest

September 2015

## From the Editor...

Thank you for your subscription to Mossberg's Investor Digest.

This Month's issue profiles **Callaway Golf Company (NYSE: ELY)**. Callaway came public in 1992 and reached a peak market cap of approximately \$3 billion in the late 90's. During the past 15 years, the company has faced a declining golf market and made several strategic missteps. As a result, the valuation has been cut by more than two thirds from its peak, and the Company had struggled to regain growth momentum and/or meaningful profitability. In 2012, Oliver "Chip" Brewer was appointed to CEO and through several strategic moves, he has put the company back on a growth trajectory, regained market share and in 2014 returned it to profitability for the first time in 5 years.

Over the next three years we see potential upside for ELY's golf equipment business alone of 50% to 75%. In addition, an IPO of Topgolf, in which ELY holds a 20% stake, could unlock an additional 30%, or \$2.50 of incremental value for ELY shareholders.

As always, I appreciate your feedback.

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## September 2015 Issue

Issue #87

Every month we hear ideas suggested from our large network of professional investors. Here are four of the ideas we heard this month, but have not reviewed in detail...

**Vishay Precision Group, Inc. (NYSE: VPG)** - VPG is an internationally recognized designer, manufacturer and marketer of systems and components based on its resistive foil technology, sensors, and sensor-based systems; specializing in the growing markets of stress, force, weight, pressure, and current measurements. VPG strives to grow shareholder value by optimizing their core operations, expand their existing product portfolio and by acquiring complementary sensor products, systems and solutions.

**Limoneira Company (NASDAQ: LMNR)** - LMNR is one of the largest growers and marketers of lemons in the U.S. and is the largest grower of avocados in the U.S. LMNR is an agribusiness and real estate development company founded and based in Santa Paula, California, committed to responsibly using and managing approximately 7,300 acres of land, water resources and other assets to maximize long-term stockholder value. The current operations consist of fruit production and marketing, real estate development and capital investment activities.

**Mesa Laboratories Inc. (NASDAQ: MLAB)** - Established in 1982, Mesa Labs has a long history of profitable growth, fueled by selected acquisitions and new product development. MLAB is a manufacturer of instruments and consumables for quality control. They operate under two divisions the instrument division that services the healthcare, pharmaceutical, food and beverage, medical device, industrial hygiene, semiconductor and petrochemical industries and the Biological indicator division that services in the hospital, dental, medical device and pharmaceutical industries.

**Sterling Construction Co. Inc. (NASDAQ: STRL)** - STRL operates as a heavy civil construction company in the United States. The company builds, repairs, and reconstructs transportation infrastructure projects that comprise highways, roads, bridges, and light rail; and water infrastructure projects, which include water, wastewater, and storm drainage systems. It primarily serves county and municipal public works departments, regional transit and water authorities, port authorities, school districts, municipal utility districts, and airport authorities.

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Best Idea Profile:

Callaway Golf Company (NYSE: ELY)

## DESCRIPTION:

Headquartered in Carlsbad, California, Callaway Golf Company was founded in the early 80's by Ely Calloway Jr., an avid golf enthusiast who had previously been President of textile manufacturer, Burlington Industries. Callaway bought a small club manufacturer and began by delivering clubs to customers from the trunk of his Cadillac.

Callaway came public in 1992 and reached a peak market cap of approximately \$3 billion in the late 90's. During the past 15 years, the company has faced a declining golf market and made several strategic missteps. As a result, the valuation has been cut by more than two thirds from its peak, and the Company had struggled to regain growth momentum and/or meaningful profitability. In 2012, Oliver "Chip" Brewer was appointed to CEO and through several strategic moves, he has put the company back on a growth trajectory, regained market share and in 2014 returned it to profitability for the first time in 5 years.

Callaway is a premium brands with a strong association with quality and innovation. To keep up with innovation, ELY spends more than \$30 million annually (3.5% of revenue) on research and development. The Company also markets products under the Odyssey putter brand, which was acquired in 1997 and the Strata brand, which offers entry-level price point clubs and balls.

The Revenue Mix is as follows:

By Product:

- Golf Balls - 15%
- Woods – 31%
- Irons – 23%
- Putters – 9%
- Accessories/ Other: 23%

By Geography

- United States – 48%
- Japan – 19%
- Europe – 15%
- Rest of Asia – 10%
- Other – 8%

## Callaway Golf Company (NYSE: ELY) Investment Data (as of 9/30/15)

<b>Recent Price</b>	<b>\$8.39</b>
52-Week Range	\$6.79 - \$10.20
Fiscal Year End	December
Dividend	\$0.07
Yield	0.5%
Shares Outstanding	78.6 M
Average Trading Volume (3 mos)	550 k
Market Capitalization	\$660 M
Cash	\$27 M
Long-term Debt	\$149 M
Enterprise Value (EV)	\$782 M
Book Value	\$4.37
P/ Book	1.9x
TTM Revenue	\$817 M
EV/ Revenue	1.0 x
FY16 EPS (consensus)	\$0.29
P/ EPS	29x
EBITDA (estimate)	\$58 M
EV/ EBITDA	13x

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## KEY INVESTMENT CONSIDERATIONS:

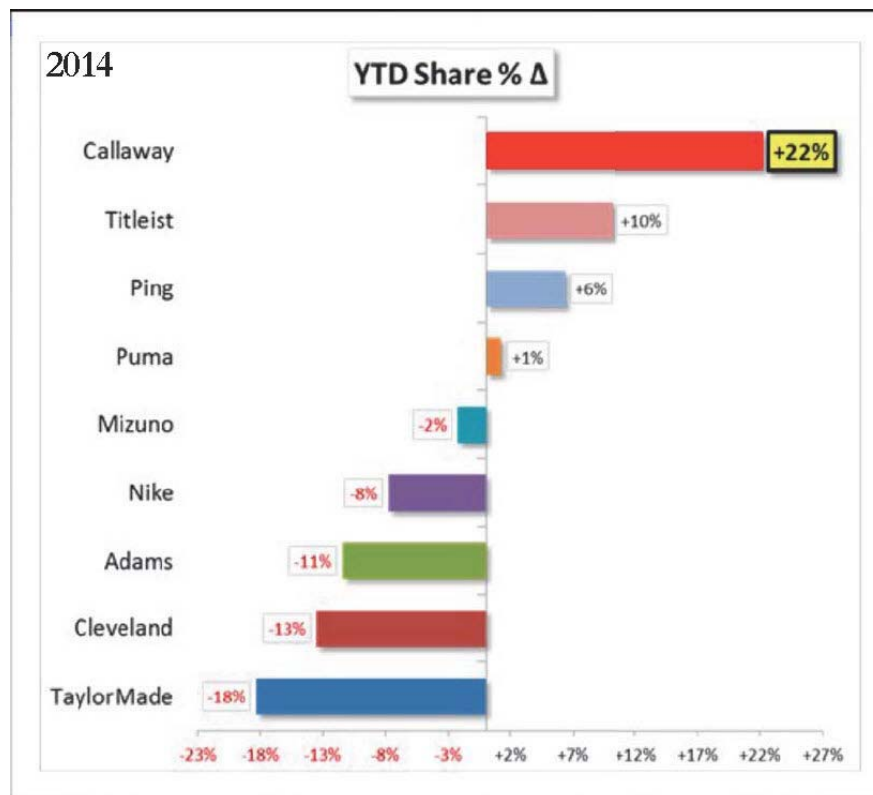
### New Management leads turn around

- **New CEO that has been there done that** – In 2012, Callaway brought in Oliver “Chip” Brewer to lead the Company as President and CEO. He had previously served as CEO of Adams Golf since 2002, and led that company during its growth period to a 175% increase in sales and its ultimate sale to TaylorMade, which occurred in 2012.
- **Key Strategic Moves** – Early on Mr. Brewer divested the company of non-core brands such as Top-Flight and Ben Hogan. He re-focused the company on its innovative roots introducing new lines of clubs such as the X-Hot club line in 2013 and the re-launch of the Big Bertha line in 2014. At the same time, Mr. Brewer initiated a \$52 million cost reduction plan designed to improve gross margins and lower operating expenses. The Company also strengthened its balance sheet and liquidity by refinancing its senior debt lowering interest costs by 365 basis points and redeeming its convertible preferred stock.

### Results of the turn around

- **Market Share Gains** - Callaway has made market share gains across all of its product categories in all three of its key regions, the US, Europe and Japan taking market share from TaylorMade

	% of 2014 Total Revenue	Hard Goods Market Share		
		2012	2014	2015
US	48%	13.9%	18.5%	21.4%
Japan	19%	10.9%	14.4%	16.2%
Europe	15%		20.3%	20.8%



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## Results of the turn around

- **Resumption of Growth** – Excluding exited product lines, the Company's core products have seen resumed mid to high-single digit growth over the past couple of years. Despite gains in market share, 2015 revenue performance is being muted due the relative strength of the dollar and its effect on weaker sales outside of the U.S.

	2012	2013	2014	<sup>^</sup> 2015 Guidance
<b>Sales*</b>	769	834	887	885
<b>% Growth Rate</b>		8%	6%	0%

\*In \$millions. Excludes sales of Americas apparel and footwear, Europe apparel, TopFlite, Ben Hogan and GPS businesses

- **Improved Profitability** – Cost efficiency efforts have driven well over ten percentage point's improvement in gross margin and lowered operating expenses. We estimate that EBITDA Margin, on a constant currency basis could approach 7% during fiscal 2015. As improvements continue, it's not unreasonable to assume 10%+ EBITDA margin for a premium branded consumer product, which leaves plenty of room for continued improvement.

	2012	2013	2014	<sup>^</sup> 2015 Guidance
<b>Gross Margin</b>	29.8%	37.3%	40.4%	45.0%
<b>EBITDA Margin</b>	-7.4%	2.5%	5.9%	7.0%

<sup>^</sup> On a constant currency basis

## Interest in Golf – The tide is out but it doesn't seem to be going lower

- **Has golf bottomed out?** - According to National Golf Foundation, the number of golfers in the U.S. is 24.7 million, the lowest level since 1995. Via reference, the numbers peaked in 2005 at 30 million golfers. According to the NGF the number of rounds played for the year through June, increased by 0.6%.
- **Discretionary Income** – Part of the decline in golf has been attributed to weakness in the economy during the last recession. While clearly a positive employment outlook, housing price recovery and lower gas prices should all bode well for the U.S. consumer, it is likely that spending will be muted in the rest of the world. With revenue split roughly 50/50 in and outside of the U.S., consumer spending it likely to have a neutral effect on ELY sales
- **New exciting players** – As one of very few golfers to win two of the three major golf championships in the same year, 22-year-old Jordan Spieth has become a name for the record books. He is being compared to Tiger Woods, Jack Nicholas and Ben Hogan. Because of his age, he is attracting more television watchers and new fans to the sport, which is critical for Golf, which has widely been reported as at risk of losing a generation of millennial players. His win at the Masters created the highest TV ratings since 2011. Spieth's win at the U.S. Open led to a 46% increase in viewers versus 2014.

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## KEY INVESTMENT CONSIDERATIONS: (continued)

### Unlocking value from potential Topgolf IPO

ELY owns a 20% stake in Topgolf a high-end driving range headquartered in Dallas. Topgolf combines a three-level indoor/outdoor driving range, upscale sports bar, pro shop, and group/corporate events center into one location. The entertainment experience is comparable to high-end bowling alley, in which players tee-off from dozens of open bays onto a course with sunken targets of various distances. Players score by hitting balls embedded with micro-chips that register as they hit each target. The foot print for a location can be 7 to 15 acres and up to 70,000 square feet. (About half the size of a Walmart Supercenter). Top golf is scheduled to have 24 units in operation by the end of this year and is opening new locations at a pace of 10 per year. Next year, Top Golf will open a flagship location in Las Vegas.

**Golfing as an excuse to drink** – As I'm sure that anyone who has played golf can attest to, golf often involves drinking. Topgolf is no exception with about 60% of revenue derived from food and beverages. Based on alcohol tax receipts, out of the 15,258 locations that report alcohol sales in the state of Texas, the lowest of the four Topgolf Texas locations ranked 84<sup>th</sup> on the list of alcohol sellers for the past two months (Top 1%). The new San Antonio location is ranked number 11. For the past two months, on average each of these four locations sold \$417,672 of alcohol per month.



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## Valuation

The table below illustrates how our "back of the envelope" calculation yields potential upside for the golf equipment business alone of 50% to 75% in the next three years. The table below shows our assumptions. In addition, an IPO of Topgolf could unlock \$2.50 of incremental value for ELY shareholders, which represents another 30% upside from current levels.

	2015	2018	
Revenue (in \$millions)	\$835	\$967	
Growth (5% annual)			
EBITDA Margin	7.0%	9.0%	
EBITDA	\$58	\$87	
EV/ EBITA Multiple	13x	13x	15x
Enterprise Value	\$782	\$1,131	\$1,305
Market Cap		\$1,006	\$1,180
Shares outstanding		80	80
Price Per Share		\$12.57	\$14.75
Upside Potential		50%	76%

**Revenue Growth:** We assume 5% growth in revenue to be driven primarily from market share gains. We also assume that there is no change in the U.S. dollar's relative strength and that market for golf equipment remains flat during the same period.

**Profitability:** We assume EBITDA margin of 9%, which equates to roughly 66 basis points of improvement per year. This margin is conservative relative to other premium brand consumer goods companies, which can produce EBITDA margins in the mid to high teens.

**Balance Sheet:** We assume that cash generated from operations is capable of supporting growth in excess cash balances and share counts will remained relatively unchanged.

**EV/ EBITDA multiple:** We use a 13 to 15 range of EV/ EBITDA valuation multiple to yield upside of 50% to 75% over the next three years, based on Calloway's golf equipment business alone.

**What is Topgolf worth?** Top Golf is rumored to be on an IPO track in the next several years, which could unlock significant value for ELY shareholders. Currently, ELY's investment is accounted for on the balance sheet for \$50.4MM, its cost basis in the investment. While specific revenue numbers are not available, media reports have suggested that Topgolf locations have done as much as \$1 million/ month in revenue and management is quoted in 2013 as saying that revenue was approaching \$100 million. Extrapolating from the alcohol sales numbers, it's not unreasonable to assume that each of these locations can do \$1 million in annual sales. By the end of 2017, if Topgolf continues to add locations at 10 per year, we end up with about 45 locations and approach \$500 million in total sales. If we apply a 25% EBITDA margin on sales, which is reasonable for similar types of venues such as Dave & Busters, we end up with \$125 million in EBITDA. With a 10x multiple, we have a valuation of \$1.2 billion in a few years. With 20% ownership, ELY's stake in TopGolf could be worth \$240 million, or \$3 per share (\$2.40 incremental to the value on the balance sheet).

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The table below shows the relative change in the value of the ideas published since March 2015 and the Russell 3000. **Performance data quoted represents past performance and does not guarantee future results.** Current performance of ideas may be lower or higher than the performance quoted.

Company	Pub. Date	Original Price	Recent Price	Change	Russell 3000 Change Since Pub. Date	Relative Perf. vs. Russell 3000
M/A-Com Technology Solutions Holdings, Inc. (NASDAQ:MTSI)	28-Mar-15	\$35.81	\$29.00	-19.0%	-9.3%	-9.9%
Kimball International, Inc. (NASDAQ:KBAL)	30-Apr-15	\$10.38	\$9.46	-8.9%	-10.0%	1.0%
Ironclad Performance Wear Corp. (OTC:ICPW)	30-May-15	\$0.27	\$0.26	-4.4%	-11.1%	6.4%
Customers Bancorp, Inc. (NYSE: CUBI)	30-Jun-15	\$26.87	\$25.73	-4.2%	-9.4%	4.8%
Potbelly Corporation (NASDAQ: PBPB)	30-Jul-15	\$13.43	\$11.00	-18.1%	-10.9%	-7.8%
Cosi Inc. (NASDAQ: COSI)	31-Aug-15	\$1.17	\$1.01	-13.7%	-4.8%	-9.6%
<b>Average</b>				<b>-11.4%</b>	<b>-9.3%</b>	<b>-2.5%</b>

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The value proposition of the digest is essentially an "Idea Generator". During the course of my 18-year career in capital markets, I've had the chance to meet and work closely with some very smart professional investors who have consistent track records of outperforming the market indexes. Some of these investors, which include mutual fund managers, hedge fund managers, and other professional investors, are kind enough to share their best ideas with me. I conduct my own analysis of their ideas and publish summaries of those ideas I think represent timely investment opportunities. Over time, I trust the majority of these ideas will pan out and help subscribers generate index-beating returns.

The goal of the Best Idea Profiles in this newsletter is to briefly describe the most relevant investment merits and risks of a company. It is not intended to be an exhaustive report including every detail. With limited space available, I am forced to include only those data points that I feel are most important for subscribers to know before they begin their own due diligence. Thank you for your interest in Mossberg's Investor Digest.

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