

Brunswick Corp.

Symbol: BC

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Lake Forest, IL

June 6, 2005

Brunswick, now producing 83% of its revenues from boats and marine engines, appears to be firing on all cylinders. In its latest conference call, the company beat quarterly estimates and boosted full-year guidance. Its stock has almost tripled in two years and now trades at a peak recovery multiple. However, a robust 2004 encouraged boat dealers to take on more inventory this year just as several leading indicators are signaling softer sales. Not only does Brunswick face a tough comparison from last year, but a wet spring, an uncertain economy and higher gas prices have dampened showroom traffic for many boat dealers. Sales of other large recreational consumer goods, such as ATVs, motorcycles, RVs, and jet skis, have all flattened or declined. Insiders are heavy sellers.

1. After a strong 2004, boat dealers have taken on higher inventories. Boat dealer MarineMax, which produces 18% of Brunswick's boat sales, shows inventories 25% higher than a year ago as of March 31st.
2. Boat sales appear to be turning down. New boat registrations for bellwether states have turned down implying lower boat sales for this spring. Consumer confidence, another strong leading indicator, has fallen 11% this year, and year-over-year registrations for fiberglass boats fell 4.2% in April.
3. Boating faces a longer-term downtrend as the number of boaters peaked in 1995 and recent unit sales of powerboats peaked in 2001. The cost of boating has risen substantially. Not only have boat prices doubled in the last ten years, but boaters face sharply higher gasoline prices this summer as well as much higher slip and mooring fees as docking spaces have become scarce.
4. Engine reliability is a critical feature of engine and boat purchase decisions. Mercury engines have been near the bottom of J.D. Power ratings for consumer satisfaction and have been criticized by independent boat dealers and manufacturers for past performance problems that they said consumers would be slow to forgive. Marine engines produce 50% of Brunswick operating profit.
5. Yamaha has made huge market share gains for marine engines in the last four years by leading the development of four-stroke technology which produces more reliable, quieter and less polluting engines. Since 2000, Japanese imports – largely Yamaha – have gone from a 43% to 59% share of the American market, and Yamaha ranks near the top of J.D. Power ratings for consumer satisfaction.
6. Evinrude's new E-TEC engines are going straight at Mercury, with better two-stroke performance and lower prices. Evinrude's parent is launching a major promotional campaign.
7. The company has high operating and financial leverage which will magnify any softness.

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Summary Company Data			
Stock price (6/6/05)	\$43.77	Price/Earnings, tl 12 mos	15.8 x
Common shares out	97.0 m	Price/Earnings, Core eps	16.1 x
Market capitalization	\$4,244.60 m	Price/Earnings, Current est	13.1 x
Shares closely held	2 %	Price/Sales, tl 12 mos	0.8 x
Potential dilution	4 %	Price/Book Value	5.0 x
Average daily volume	606.0 k	Book Value (tangible)	\$840.6 m
Estimated daily dollar vol	\$26.5 m	Short interest, February	1.7 %
Debt/Capital (tangible)	62 %	Short interest, March	2.2 %
Auditor:	Ernst & Young	Short interest, April	3.1 %
Fiscal Year End:	December	Short interest, May	3.1 %



Company Description (from Hoover's)

Brunswick's business is everyone else's free time. A global leader in the leisure products industry, Brunswick's pleasure boat brands include [Sea Ray](#), Bayliner, Boston Whaler, Lund, and [Hatteras](#), just to name a few. The company also makes marine engines ranging from 40 to 275 horsepower under the Mercury and Mariner nameplates. It also makes Brunswick bowling and billiards products, as well as

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fitness equipment ([Life Fitness](#), ParaBody, and Hammer Strength). Brunswick owns or franchises more than 115 fun centers throughout Canada, Europe, and the US that feature bowling, billiards, restaurants, and "Cosmic (glow-in-the-dark) Bowling."

The Bull Story

The Brunswick strategy is working. In its latest conference call at the end of April, the company announced results of continuing earnings per share of \$.64, excluding a one time gain, which beat analyst estimates by \$.04 per share, and the company also boosted full-year 2005 guidance by \$.05. The company plans to reap huge benefits through the vertical integration of a complete line of powerboats with its Mercury engines. This will provide consumers with a one-stop process that is simpler and similar buying a car. By doing this, Brunswick can offer a more efficient package to the dealer and a more reliable product to the consumer. Brunswick's consolidation of a range of boat builders also creates economies-of-scale in purchasing, distribution and in shared manufacturing technologies. The company has invested heavily to improve its engine technology, and its highly regarded management could redefine how consumers buy pleasure boats.

Boating: A Flat Market Even With Easy Credit

Through acquisitions, Brunswick has become a boating company, with the sale of marine engines and boats producing 83% of its revenues in the trailing 12 months as of March 31st. As a result, the company's net income grew with the boom in discretionary consumer products, and its stock almost tripled in the last two years. Wall Street analysts, using the old saw that the boating industry follows 11 year cycles – eight up and three down – have waxed hopeful that boating has entered the early stages of a long up cycle. However, the company now trades at 16x earnings – the top end of a recovery multiple – and depends on a highly cyclical business that is usually "the first to go and the last to come back" just as wet weather and an uncertain economy have dampened traffic at dealer showrooms.

In addition to being cyclical, boatbuilding is highly competitive. Even though three companies – Brunswick, Tracker and Genmar – account for 40% of boat sales, low barriers-to-entry keep the industry fragmented. As a result, boat builders typically produce low returns – Brunswick's boat division produced an operating margin of only 6.8% in the last 12 months.

Boatbuilding has also benefited from easy credit. Consumers use financing to pay for most boat purchases. While unit sales of power boats have stagnated in the last four years, dollar revenues have risen – by 8% in 2004 alone – largely due to easy credit, which credit has encouraged consumers to buy bigger boats. Since 1996, the price of an average powerboat has more than doubled. Not only has boat credit been easy, but the spate of home refinancing in the last several years undoubtedly funded more purchases and helped satisfy consumer demand. Even with easy credit,

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the market for powerboats has been shrinking slowly. The number of people participating in boating peaked in 1997 and has since fallen by 9%, and unit sales of powerboats peaked in 1973 and have since 2000 declined 14%.

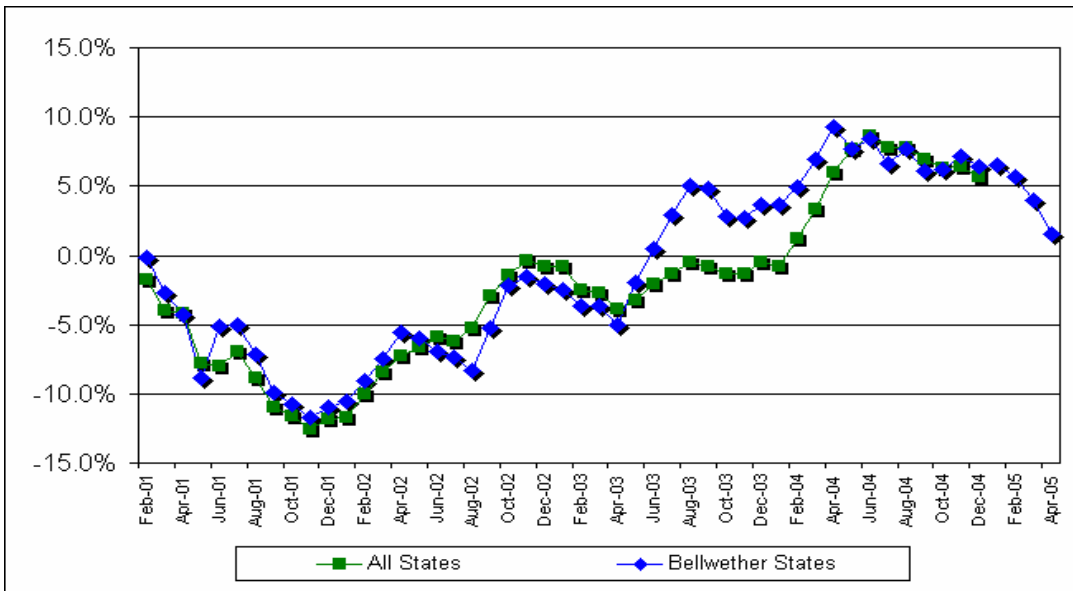
In addition to a flat market, powerboat manufacturers face rising material and environmental costs. Boats are made from resin, wood, steel and aluminum, prices of which have all increased substantially in the last two years. However, in its most recent conference call, Brunswick management said raw materials costs amount to no more than 4% of revenues, and the company could keep raw materials inflation to 1%. The engine market has also been facing rising costs due to tougher environmental standards. Both the Environmental Protection Agency and the California Air Resources Board have mandated tougher emission standards each year until 2006. Brunswick has invested over \$100 million in its new line of Vorado engines that meet environmental guidelines.

After a Banner 2004, Boat Production and Inventories Rise

The good news is that sales of powerboats rose last year to the second highest year on record. However, those strong sales encouraged boat dealers to take on more inventory for 2005. *Boating Industry* reports that at the very end of 2004 wholesale sales outpaced retail sales, which means that inventory rose at dealers (December 28, 2004.) More specifically, MarineMax, Brunswick's largest dealer that accounted for 18% of its boat sales in 2004, saw inventories rise 25% from a year-ago as of March 31st. Brunswick also ramped up inventories at other dealers. As of March 31, 2005 its marine engine inventories at its dealers rose from 22 weeks a year ago to 26 weeks, an 18% rise. And, its dealer boat inventories rose from 28 weeks to 31 weeks, an 11% increase.

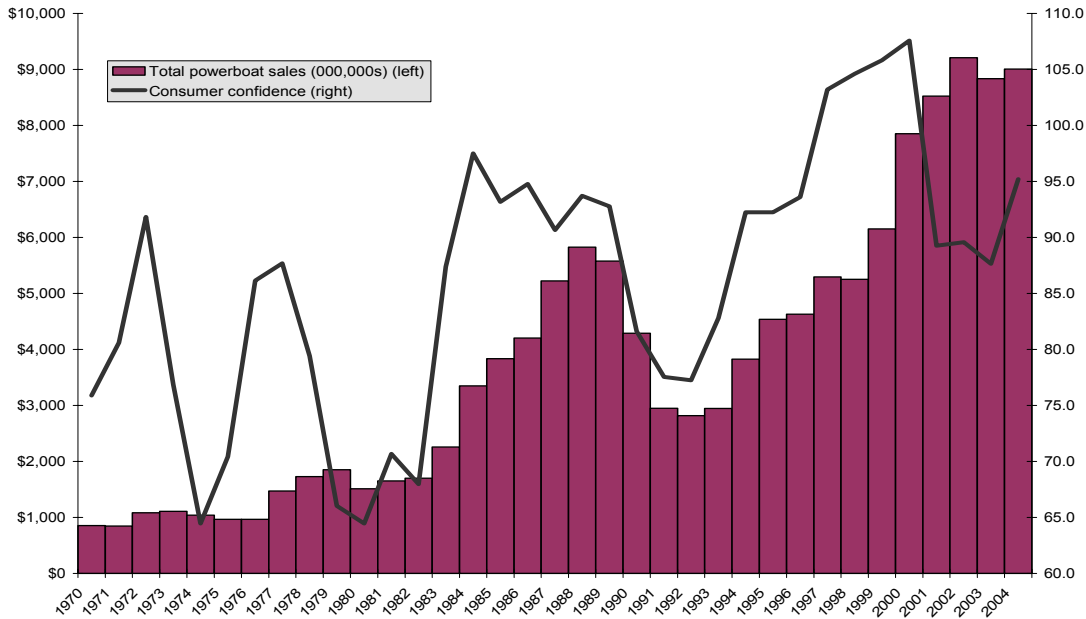
As Boat Inventories Rise, Demand Softens

Just as manufacturers have built boat inventories at the dealer level, consumer demand has shown signs of softening. The following chart lists monthly changes in powerboat sales as reported by the National Marine Manufacturers Association ("All States" on the chart.) The chart also shows the trend in new boat registrations for leading "Bellwether States," which in the past has been a leading indicator of powerboat sales.



Source: InfoLink

Consumer confidence is another leading indicator for boat sales. The following chart shows that consumer confidence as measured by the University of Michigan poll has led or coincided with powerboat revenues. Recently, for example, consumer confidence rose in 2004 as did domestic boat purchases. By last month, however, University of Michigan poll fell to 86.9 implying tougher sledding for upcoming boat sales. It is not the best time for flagging consumer interest – the second and third quarters of the year are traditionally the busiest boat season.



Source: National Marine Manufacturers Association and University of Michigan

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New figures just released confirm that boat sales are starting to soften with lower consumer confidence. On June 1st, *Statistical Surveys* said that preliminary figures show that registration data for April sales of fiberglass boats in the popular 14- to 30-foot segment fell 4.2% from April 2004. Sales of aluminum boats fell 2.3%. The *Statistical Surveys* sample covers 37% of the U.S. boating market and includes the largest boating states of Florida, California, New York, Texas, Michigan and New Jersey.

Boat sales also face long-term hurdles in addition to sagging consumer confidence. Higher gas prices have raised the operating cost of boating. Wall Street analysts seem to think that higher gas prices will have little, if any, effect on boat sales on the theory that anyone who could afford a \$40,000 boat isn't going to worry about a few pennies increase in gasoline (although a \$1.50 per gallon rise in the price of gas means that the fill-up on a 200 gallon tank costs an additional \$300.) Dealers feel differently. They say that higher gas prices cause current owners to pause before trading up to a bigger, gas guzzling boats. A *Boating Industry* poll of dealers taken last summer asked what would be the result if gas prices remained high, and almost 50% said that boat sales would decline. Only 27% said that it would have not impact on boat sales.

Crowded public access and a shortage of dock slips and moorings also appear to be a challenge to further boat sales. In Sarasota County, Florida, the number of moorings available to the general public has declined since 1998 as developers bought marinas and boatyards for condo development. This has caused fees for boat space to soar – double or even triple the rates of a few years ago. And, a shortage of ramps as well as higher gas and environment issues have stalled new boat registrations in Broward County and across Florida (*Florida Today*, April 5, 2005). Dealers on the east coast, from Cape Cod to Florida, have reported the lack of slips and moorings are retarding sales for larger boats. A recent *Boating Industry* poll asked boat dealers how much impact water access had on their business. Over 65% answered that it had a significant impact, while only 9% said none at all.

New powerboat sales in the last few years have also created a surplus of used boats as consumers traded up to larger models. Well-maintained used boats retain their functionality for decades and thus compete with new boats, and anecdotal evidence shows several areas across the northeast and mid-west with high used boat inventories.

Mercury Engines Need to Overcome a Reputation for Performance Problems

Brunswick has turned itself into a boating company through acquisitions. In 1986 it purchased two of the world's largest boat manufacturers, Bayliner and Sea Ray, and has subsequently added a slew of smaller companies. Its line now ranges from small aluminum dinghies to yachts. The company acquired Land 'N' Sea and Attwood in 2003 and seven brands, including Lund and Sea Pro, in 2004. However,

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the company still derives most of its operating income from the sale of marine engines. In the trailing 12 months as of March 31st, the company earned 41.4% of its revenues but 50.4% of its operating income from its Mercury and Mariner engine group. However, engine sales for powerboats are closely tied to new boat sales: most marine engines are sold on a new boat. As such, many boats are pre-rigged for a specific engine brand, and many are sold as a package with a boat and a trailer. So, with each new acquisition of an independent boat brand, Brunswick can now pre-rig or package that line for Mercury or Mariner engines.

Whether that strategy will help engine sales or hurt boat sales is unclear. From the consumer's perspective, engine reliability is a critical factor in the buying decision. In the saltwater market, for example, consumers are more loyal to a particular engine than a boat brand. No boater wants to be stuck on the water with a failed engine, especially on the ocean. J.D. Power and Associates recently reported (February 17, 2005) that engine problems are the most reported boat issue, and poor performance produces low customer satisfaction and loyalty. Eric Sorenson, director of the marine practice at J.D. Power, said, "It's clear from the data new to the study in 2005 that customers want to be able to choose their engines as well as their boats."

Brunswick's Mercury and Mariner engine brands face tough competition from Japanese imports, Yamaha in particular. In the last four years, Yamaha has trounced domestic competition. J.D. Power and Associates' 2005 "Marine Engine Competitive Information Study" ranked Yamaha highest in two-stroke outboards and second in four-stroke outboards, the most popular outboard motor segments. Yamaha's four-stroke engine ranked highest in the 2003 and 2004 surveys, and its two-stroke ranked highest in 2003. Mercury engines fall near the bottom of the lists. From 2000 to 2003, the share of Japanese engines rose from 43% to 59% of the domestic marine engine market, and Yamaha now has a 50% share in the market for engines over 100 horsepower.

Yamaha has built engines with a reputation for reliability, and it captured that market share in spite of charging higher prices than Mercury. The retail price for a Mercury 150 horsepower engine, for example, runs about \$8,100 whereas a Yamaha engine with the same horsepower sells for \$10,200. In addition to a reputation for reliability, Yamaha led the development of four-stroke engine technology. Domestic manufacturers Brunswick and Bombardier (now Bombardier Recreational Products or BRP, maker of Evinrude and Johnson engines) were slow to introduced four-stroke engines, now more popular with boaters. The recent J.D. Power and Associates 2005 Marine Engine Competitive Information Study found that consumers had higher satisfaction with electronic fuel injected four-stroke outboards than direct injected two-stroke outboards. Four-stroke outboards now account for 50% of the coast fishing market, up from 31% in 2003.

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After Yamaha built an imposing market presence in the last several years, Brunswick's Mercury Marine filed a complaint in January 2004 with the International Trade Commission accusing Yamaha of dumping marine engines in the United States at a price below the price that it charged in Japan. In ruling against Brunswick, the ITC found that the growth in the U.S. outboard engine market in the last several years was entirely due to increased demand for four-stroke technology, which produces engines that are more durable, reliable, and quieter than two-strokes, as well as being fuel efficient, emissions-compliant and requiring no manual gas/oil mixing. Brunswick and BRP were slow to introduce four-stroke engine technology – Japanese producers offered four-stroke engines over 115 horsepower much earlier than domestic producers.

The commission found that only a small portion of the market, most notably bass boaters, clearly preferred two-stroke direct injection engines because of speed and acceleration. Those that testified against Brunswick's position, including boat builder Genmar and independent boat dealers, also claimed that Mercury's two-stroke Optimax engine had a reputation for being unreliable, or as Genmar President Irwin Jacobs testified, "Over the years, problems with this engine are legendary in the marketplace...." (Transcript of the United States International Trade Commission, Investigation No.: 731-TA-1069 (Preliminary), January 29, 2004.)

In the same hearings, Doug Gomes, Vice President of Sales and Marketing for Grady White Boats said, "Starting with the 2003 model year, we offered either a Yamaha package or a Yamaha pre-rigged boat for sale to our dealers. We no longer off the option of pre-rigging for either Bombardier, Mercury or any other outboard engine." He went on to say, "In terms of two-stroke direct injection engines, both Mercury's Optimax motors and Bombardier's Ficht technology motors experience numerous technical problems, not small problems, but major powerhead problems, when they were introduced in the market, problems which have yet not been completely resolved." He felt that it would take time for the public to trust that those issues are gone. Jack Mudgett, President of Action Marine, a large dealer specializing in the freshwater market, also testified in those hearings that, "Evinrude's Ficht engine was horrible, but Mercury's Optimax was, if anything, worse." From this testimony, it appears that Mercury has to overcome a lower-quality image.

After the anti-dumping complaint, Yamaha raised the price of its powerheads to Brunswick by 91.5%, prompting Brunswick to file a lawsuit against Yamaha in Green Bay, Wisconsin that ironically demanded that Yamaha sell powerheads at a contractual price that would have been lower than Brunswick's anti-dumping complaint (Brunswick later excluded powerheads from its anti-dumping petition, *Knoxville News-Sentinel*, October 22, 2004.) After Brunswick lost the anti-dumping complaint, it settled its powerheads dispute with Yamaha at the pre-dispute price. However, it seems that Brunswick has an adversarial position with several large suppliers and customers.

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In response to Yamaha's success with four-stroke engines, Brunswick has spent \$100 million to develop a new Verado outboard engine, which debuted this winter in four high-end models of 200 to 275 horsepower selling for about \$18,000. In this new four-stroke line Brunswick uses only parts produced in-house rather than those supplied by Yamaha. But, Brunswick may have to overcome as well the image from past problems with Mercury engines.

As Mercury takes on Yamaha, it also faces a much stronger challenge from a restructured Bombardier Recreational Products (BRP.) BRP is going straight at Mercury engines with its new Evinrude E-TEC technology. Like Optimax, Evinrude Ficht technology suffered with performance problems several years ago, resulting in recalls and substantial warranty costs that drove its then parent Outdoor Marine into bankruptcy. Bombardier bought the engine group – the well-known Evinrude and Johnson brands – from bankruptcy, then sold the division at the end of last year to members of the Bombardier family, Bain Capital and Caisse de Depot et Placement du Quebec. Now with rave reviews for its new E-TEC design and higher J.D. Power ratings, BRP has begun its first major advertising campaign comparing E-TEC engines to Mercury's new Verado line. BRP engines appear to be even lower priced than Mercury engines.

Boat dealers and customers are traditionally cautious about changing engine loyalty, waiting several years to see if a new technology proves reliable. So, any inroads made by these new Mercury and BRP products will likely occur gradually.

Brunswick's Vertical Strategy Could Create Customer Conflicts

By offering a wide range of marine engines and boat styles and sizes, Brunswick wants to offer dealers a fully-equipped boat with 100% Brunswick products. Its consolidation of boat manufacturers, however, has made independent boat builders, many who buy Brunswick engines, uneasy. The independents have responded by forming buying consortia, such as the United Marine Manufacturers Association and Independent Boat Builders Inc., to purchase bulk raw materials that can match Brunswick's economies of scale. The UMMA president even urged members to avoid buying Brunswick engines because, he said, "Brunswick intends to put you out of business." (Ventura County *Star*, March 15, 2005)

Brunswick actually sells most of its engines to other boat building companies to power their boats. So by vertically integrating, the company has become both a supplier and a competitor to its large customers which creates unusual conflicts. Genmar is Brunswick's largest boat competitor (15.7% of the market in 2003 vs. 17.3% for Brunswick according to *Statistical Surveys*) and at the same time one of its largest customers for Mercury engines. After Genmar bought the boatbuilding division of Outboard Marine in bankruptcy, Genmar CEO Irwin Jacobs testified at the ITC hearing that Mercury tried to raise prices by 10% in order to take advantage

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of an engine shortage, while Yamaha did not. According to Jacobs' testimony, "...the point being that they [Mercury] thought they could take advantage of OMC's demise and raise our engine prices."

When Brunswick buys boat brands, it tries to rig those boats with Mercury engines. After Genmar sold the Lund, Crestliner and Lowe brands to Brunswick in 2004, Brunswick rigged more boats with Mercury outboard motors, causing some discomfort and anger among boat dealers effectively limited to sell only Mercury engines on some of those lines (Minneapolis *Star Tribune*, January 16, 2005.)

Rival engine makers, feeling threatened by Brunswick's concentration in boat manufacturing, are beginning to retaliate. After Brunswick bought Sea Pro, Sea Boss and Palmetto Custom saltwater boat companies in January, both Yamaha and BRP announced the cancellation of their engine contracts with all three companies (*Boating Industry*, April 6, 2005.)

Brunswick's High Operating Leverage Adds to Its High Financial Leverage

The high fixed cost boat and engine business carries substantial operating leverage. As Brunswick sales increased by 39% in the last three years, its net income grew 230%. However, leverage works both ways, and the company's adds to performance risk with additional financial leverage. As of March 31, 2005, Brunswick carried long-term liabilities of \$1,377 million with only \$841 million of tangible equity giving the company a long-term liability to tangible capital ratio of 62%.

Brunswick's financial leverage would be worse if the ratio included \$312 million in off balance sheet customer financing guarantees. The company has moved dealer financing and part of its receivables off its balance sheet through the creation of Brunswick Acceptance Corporation (BAC). Brunswick created BAC in 2002 through a joint venture with Transamerica (now GE Commercial Finance.) BAC provides wholesale floor financing for Brunswick customers, which Brunswick guarantees, but because Brunswick only owns 49% of BAC, it does not show that leverage on its balance sheet. Instead, it can account for its position using the equity method, which shows its net investment in BAC only as a long-term asset on the balance sheet, and it records any income or loss in other income on its income statement. As of March 31, 2005, Brunswick had exposure to \$408 million in off balance sheet guarantees. BAC also factors Brunswick receivables (for Mercury engine sales), adding cash to the balance sheet and skewing free cash flow. During 2004, Brunswick sold \$928 million of receivables to BAC, and the end of March 2005 had an outstanding balance of receivables sold to BAC of \$97.5 million, which effectively moved 16% of receivables off the balance sheet as of March 31st.

In spite of moving those receivables off its balance sheet, Brunswick produces negative free cash flow. Because acquisitions of boat companies are an on-going

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strategy to grow revenues and capture engine contracts, the net cash for acquisitions is included in a calculation of free cash flow.

Reported Free Cash Flow						
	<i>Dec03</i>	<i>Mar04</i>	<i>Jun04</i>	<i>Sep04</i>	<i>Dec04</i>	<i>Mar05</i>
Revenues	1086.900	1199.600	1422.700	1273.200	1333.800	1401.100
Cost of goods sold	778.100	864.000	1016.300	915.600	961.700	1020.800
Gross profit	308.800	335.600	406.400	357.600	372.100	380.300
Gross margin	28.4%	28.0%	28.6%	28.1%	27.9%	27.1%
Net income	39.900	48.000	90.100	72.900	58.800	94.600
Net income per share	\$0.43	\$0.50	\$0.93	\$0.75	\$0.59	\$0.96
Cash from operations	90.000	-15.200	185.200	80.100	165.100	-69.300
Capital expenditures	66.100	32.500	40.200	41.300	57.300	32.500
Free cash flow	23.900	-47.700	145.000	38.800	107.800	-101.800
Acquisitions	4.7	196.200	17.800	-0.100	53.900	13.7
Free cash flow adjusted	19.200	-243.900	127.200	38.900	53.900	-115.500

The table shows that in the last six quarters, Brunswick consumed \$120.2 million of free cash flow. This cash consumption could pressure the company's leveraged balance sheet. The table also shows that Brunswick gross margins have fallen for three consecutive quarters.

Management

Insiders have been heavily sellers of Brunswick stock for the last year. In the last twelve months, insiders have sold approximately 832,000 shares for \$37.7 million. Insiders have also been substantial sellers recently. Since February, insiders have sold 130,000 shares for \$5.8 million.

In a move that seems to limit outside review, Brunswick does not allow Thomson StreetEvents to post a transcription of its conference calls. Instead, it posts a transcription on its own Web site, and eliminates the portion of the transcript for questions and answers.

Catalysts

- Given Brunswick's comments in the last conference call, it is likely to meet 2Q05 guidance. However, widespread reports of higher dealer inventories and lower sell-through, particularly in the northeast and mid-west could cause the company to lower guidance.
- Lower consumer confidence and higher gas prices could slow summer sales. Manufacturers of ATVs, RVs and motorcycles have all lowered expectations.

- Tighter credit standards for boat loans or fewer home refinancing would have a dramatic effect on boat sales.
- The least predictable but more important short term catalyst for boat sales is often the weather. A rainy spring in the northeast, southeast and parts of the west coast could make it more difficult to meet 2Q05 estimates.