This 3DAdvisors Report Covers:	
✓	**Insider Trading**: Insider Trading Behavior
	Accounting: Quality of Earnings Issues
✓	**Governance:** Corporate Governance Issues

Trading and Governance Behavior Enrich Insiders Harley-Davidson Inc. (NYSE:HDI)

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Harley-Davidson, Inc. (HDI) is the parent company for the group of companies doing business as Harley-Davidson Motor Company, Buell Motorcycle Company and Harley-Davidson Financial Services. Harley-Davidson Motor Company produces heavyweight motorcycles and offers a line of motorcycle parts, accessories, apparel and general merchandise. It manufactures five families of motorcycles: Touring, Dyna Glide, Softail, VRSC and Sportster. Buell Motorcycle Company produces sport motorcycles, including four big-twin XB models and the single-cylinder Buell Blast. Buell also offers a line of motorcycle parts, accessories, apparel and general merchandise. Harley-Davidson Financial Services provides wholesale and retail financing and insurance programs, primarily to Harley-Davidson/Buell dealers and customers.

Summary of 3DAdvisors Findings for HDI

- **Governance:** Incentive compensation changes that benefit management
- **Governance:** A couple of disclosed, but nonetheless interesting board conflicts
- **Insider Trading:** Significant holdings reductions a break from prior behavior

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Discussion of 3DAdvisors Findings

Following up on our coverage of HDI in the *Insider Research Bulletin* of 8/3/04, we have made new observations that have led us to ask whether Harley Davidson is being run in the best interests of the shareholders or whether management and the board have structured the operation in ways that lean toward the interests of insiders. In addition to our initial findings, which revealed a convergence of insider holdings reductions, we have found evidence that certain compensation strategies have been altered, by the board, significantly tipping the scales in favor of management. New compensation metrics are aided by share buybacks which not only have intensified to all-time high levels but also have been supplemented by new, aggressive, board sanctioned repurchase authorizations.

Granted, our findings do not indicate the presence of an imminent catalyst likely to bring the share price down in the near future. However, certain behaviors exhibited by the board and management reveal a proclivity towards self-serving dealings that may very well extend beyond what is disclosed by the Company. This, combined with the increase in insider selling to record levels, presents to us a risk profile that may not be currently evident to most investors and, therefore, something we feel our clients should be aware of.

Governance: Incentive compensation changes that benefit management

Followers of Harley-Davidson know that the Company benefited from a windfall year, in 2003, from its 100th Anniversary Celebration. A fiercely loyal clientele, most of them in the sweet spot of their earning years, needed little convincing from the Company to participate, mostly by buying motor cycles, accessories and apparel over the course of the year-long event. Given this windfall, the Company's incentive plans, in their then-existing form, provided adequate opportunity for high-level executives to reap the benefits of Harley's legacy as if it were their personal accomplishments. Award payouts under the Short Term Incentive Plan (STIP), which benefited senior executives including both CEO and Chairman **Jeffrey Bleustein** and CFO **James Ziemer,** were tied to consolidated net income (as they had been since at least 1999) for 2003. With the 100th Anniversary in full swing, it was not difficult to envision a big compensation year for Harley's top management, and indeed it was. In 2002 and 2003, for example, Bleustein received a $3.5 million in bonus compensation, each year, in addition to his $861,283 base salary.

A significant part of Bleustein's 2002 and 2003 bonuses ($1.5 million each year) was awarded under Harley's Deferred Long-Term Incentive Plan (Deferred Plan) which was adopted in May of 2002, just before the beginning of the 100th Anniversary Celebration. This plan was adopted by Harley's board "for Mr. Bleustein to recognize his past contributions to the Company and give him an incentive for future performance." The Deferred Plan gave the Human Resources Committee (Harley's board has no Compensation Committee) "the flexibility to award bonuses of up to an aggregate amount of $5 million to Mr. Bleustein during the years 2002 through 2006." So, in just the first two years of the Deferred Plan, the windfall period of the 100th Anniversary Celebration, Bleustein was awarded 60% of the total allowable under the five-year Deferred Pan.

But there's much more here. In the wake of the 100th Anniversary Celebration, it seems that the Human Resources Committee (with Bleustein's blessing, we're certain) made sure that his cash incentive bonuses would remain alive and well even should the windfall sales slow. This was done by altering, for the first time, the sole performance criteria for the Corporate STIP formula for 2004 "to better align the Corporate STIP with shareholders' interests." This was quietly accomplished by changing the performance criteria from consolidated net income (where it had been for at least the past five years) to earnings per share.

Given this, it should be no surprise that, in Q1 of F/Y 2004, Harley embarked on the most aggressive repurchase program in its history. In order to do this, the board had to do something about the Company's outstanding authorization, an ongoing one that was tied to a ratio of the number of Harley shares outstanding and the exercise of stock options occurring on or after January 1, 1998. To get around this restriction, the Board approved a separate authorization, in 2003, that would allow the Company to repurchase 9.4 million shares, irrespective of the cost. After purchasing 1.6 million shares under this second authorization in 2003, the Company exhausted the remaining 7.8 million authorized for repurchase by buying the shares in Q1 of 2004, just as Bleustein and Ziemer's new plan, based on EPS, kicked in.

Consequently, in Q1 of 2004, Harley spent $403 million repurchasing shares, shares which of course had been trading at all time highs. For the past three years (2000 through 2003) the average spent on repurchases annually had been just $91 million with the highest year being $111 million. Since the Q1 repurchases exhausted the newest repurchase authorization, the Company and the board moved quickly to approve a new one. This time it authorized the buyback of up to an additional 20 million shares of common, irrespective of share price.

Governance: A couple of disclosed, but nonetheless interesting board conflicts

Harley Davidson insiders have some interesting, albeit disclosed, related party dealings. What is interesting is the fact that the board, in each case, has chosen to waive any attendant conflict of interests:

A board director, **Donald James**, is the CEO and an equity owner of the largest independent motorcycle dealership in Canada. The company is the exclusive distributor of Harley Davidson motorcycles in Canada. Harley's Nominating and Corporate Governance Committee, however, "has waived any conflict of interest that this relationship may represent."

Director **George Conrades** (also a Cardinal Health director) is Chairman and CEO of Akamai Technologies. Harley and Akamai have a commercial relationship under which Akamai provides internet content distribution services to Harley. Not only has Harley's Nominating and Corporate Governance Committee deemed that this relationship does not preclude Conrades from qualifying as an independent director, but it has also "waived any conflict of interest that this relationship may represent on the basis the relationship existed before Conrades joined the board." What's interesting in this particular case is the fact that this relationship was not disclosed in Harley's 2002 proxy, even though Conrades was on the HDI board at that time.

In yet another situation, Harley General Counsel, **Gail Lione**, is married to a partner in the law firm of Foley & Lardner LLP. In 2003, Harley paid Foley & Lardner $1.8 million for legal services. As in the other two cases, a Harley board committee "has waived any conflict of interest that this relationship may represent".

Insider Trading: Significant holdings reductions a break from prior behavior

As we mentioned in the *Insider Research Bulletin* of 8/3/04, we took note when nine Company insiders (a new one surfaced after our report) broke from their typical trading behavior to sell 1,359,672 shares between April 14th and July 27th at prices between $57.80 and $63.35 each. The reductions in holdings of those involved, most notably Chairman and CEO Jeffrey Bleustein, caught our eye. In fact four of the sellers, highlighted below, had decreased their holdings by between 29% and 59% each.

Figure 1. Harley Davidson Daily Closing Stock Prices, September 2, 2003 through August 6, 2004. Blue shaded area is the period where insiders sold approximately 1.4 million shares. Sources: Reuters and Vickers.

- **Jeffrey Bluestein (64)** – Chairman, CEO. Since 1995, Bleustein, who has been the driving force behind Harley, had only executed three prior sales totaling 1.05 million shares. His last transaction was a 240,888-share sale in October 2001 at $48. We immediately took notice when he began selling on April 15th and winded up monetizing 848,000 shares through July 20th, grossing $51.7 million. In addition to the activity being historically large, Bluestein exercised four series of non-expiring options (expiration dates: 2/05, 2/06, 2/07, 2/08) equal to two-thirds of his vested options to acquire the shares. Bleustein's sales **reduced his holdings by an unprecedented 41%**.

- **James McCaslin (55)** – President, COO, Harley-Davidson Motor Company. Like Bluestein, McCaslin aggressively exercised roughly two-thirds of his vested options (four different series set to expire between February 2006 and February 2009) and sold the underlying 176,934 shares at just over $58. The sale, which was his largest since registering as a Section 16 filer, **reduced his actionable position by 41%.** In the past five years McCaslin's only two prior dispositions were a 5,000-share sale in January 1999 and a 136,980-share sale in January 2000 at $35. It is rumored that McCaslin is the heir apparent to the Harley CEO position when Bluestein retires.

- **Donna Zarcone (46)** – President, COO-Harley-Davidson Financial Services. On July 15th Zarcone executed her first sale since filing in 1998, exercising a substantial portion of her vested options to acquire the shares. The 82,108-share sale which grossed over $5 million **decreased her holdings by 59%.** In August 2002, shortly after the Company implemented ownership guidelines, Zarcone purchased 4,400 shares at $43. The recent sale leaves her with just 10,000 shares of common stock, well short of the amount she is required to hold by 2007.

- **Ronald Hutchinson (56)** – V.P., Parts, Accessories, Customer Service. Hutchinson is another seasoned Company exec that recently sold, yet is far from meeting his ownership requirements. On April 15th he sold 42,234 shares between $58.27 and $58.54, which drained his common stock holdings to a mere 364 shares. Not only did it lessen his common holdings, but also **trimmed his actionable position by nearly 30%.** This sale was Hutchinson's largest in the past ten years – he last sold 10,000 shares in August 2003 at $50.

Also selling was CFO James Ziemer and General Counsel Gail Lione, who sold 93,972 and 24,696 shares, respectively. With the exception of a 4,400-share sale in August 2003, this was Ziemer's first notable sale in the past eight years. Lione last sold 50,000 shares in July 2001, which preceded a two-month, 35% slide in the stock.