Harley-Davidson: Uneasy Rider

The stock has been riding high in Washington and on Wall Street. But it could be headed for a nasty spill.

Sagging sales could send Harley-Davidson into a nasty spill. *Harley-Davidson*

“It’s great to have Harley-Davidson,” said President Donald Trump as he welcomed executives and union reps from the American motorcycle maker to the White House early this month. “What a fantastic job you do,” the president told his guests, who parked their five Harleys near the South Lawn.

Even critics would find it tough to fault this presidential plug. Harley-Davidson (ticker: HOG) deserves acclaim: Its motorcycles have carried the nation's soldiers, cops, and biker clubs down U.S. highways for a century. The machines have starred in Hollywood movies like *Easy Rider*. The company's business has become remarkably successful, too. It's No. 1 in the domestic market for heavyweight bikes, fending off foreign challengers for decades, and is growing exports from its unionized plants even in the face of a strengthening U.S. dollar.

The Milwaukee-based company is one of the homeland manufacturers that would benefit from Trump's plan to cut taxes and award border adjustments favorable to American-made goods. That has helped Harley shares outperform the market over the past 12 months, advancing almost 35%, to a recent price of $56.56, which leaves their valuation near the high end of their historical range. But a couple of curves threaten to throw the stock into a skid.

Demographics and the dollar present challenges that even the president can't fix. America's population of middle-age white guys, the restless heart of the company's market, is shrinking. Attempts to sell to other demographic groups are fighting a decline in motorcycle ridership. Meanwhile, the increasingly mighty dollar crimps the profitability of Harley's foreign sales.

CEO Matt Levatich knows that Harley can't just make bikes—it has to create demand. "The headline goal," he says, "is to build the next generation of Harley riders globally." The U.S., Canada, and Japan are mature markets for motorcycles, say Levatich, so the bulk of the company's growth must come from emerging markets like Asia—when those economies can afford an expensive leisure-sport product like a Harley-Davidson.

For now, though, the Harley growth engine has hit a demographic flat spot: It has missed annual shipment targets for several years running. Harley will remain a roaring icon of U.S. manufacturing. But for the next stretch of bad road, it's an icon whose shares should probably trade in the high $40s, not the high $50s.

A FAST HISTORY: The company's first motorcycle, in 1903, was basically a bicycle with an engine. The "hog" nickname for Harley bikes dates from the 1920s, when its racing team's piglet mascots rode along on victory laps. Since the company returned to the public markets in 1986, following a management-led buyout for just $65 million, its stock has outperformed the market by more than 16-fold to reach an enterprise value of $16.5 billion.

After wobbling through the financial crisis—with help from Warren Buffett and state and federal governments—Harley came back to drive its sales to $5.6 billion in 2014 from $4.2 billion in 2010, as its motorcycle shipments grew to 270,000 from 210,000. Profits rose more impressively at the tightly run business, expanding to 2014's $845 million, or $3.88 a share, from 2010's $147 million, or $1.11 a share.

CEO Matt Levatich *Hemant Mishra/Mint/Getty Images*

The company's business is straightforward. Nearly 80% of revenue comes from selling big-engine road bikes that cost as much as $30,000 apiece. Parts, accessories, and licensed merchandise bring in the rest. It's seasonal, with two-thirds of sales occurring in each year's first half—before summer road trips. A wholly owned financing unit extends credit to dealers and buyers.

Management has provided shareholders with a nice ride, giving them an increasing portion of the cash thrown off by the business, through cash dividends and stock buybacks. When sales slipped to $5.3 billion in 2015, Harley bought back enough stock so that earnings per share fell only slightly, to $3.69. Sales slipped again in 2016, to $5.27 billion, but while net income fell 8%, stock buybacks actually allowed EPS to rise 4%, to $3.83. Its oftraised dividend now yields 2.5%.

Sales have stalled because Harley's core buyers—middle-age non-Hispanic white males with a comfortable income—have declined in number in the past decade (see chart, above left). U.S. Census projections for the core of that group, ages 45 to 49, foresee the fall continuing for at least another five years. The numbers in other brackets of that midlife demographic, ages 35 to 60, are projected to flatten out but not recover to earlier levels. In foreign markets like Europe and Japan, the trends are just as daunting.

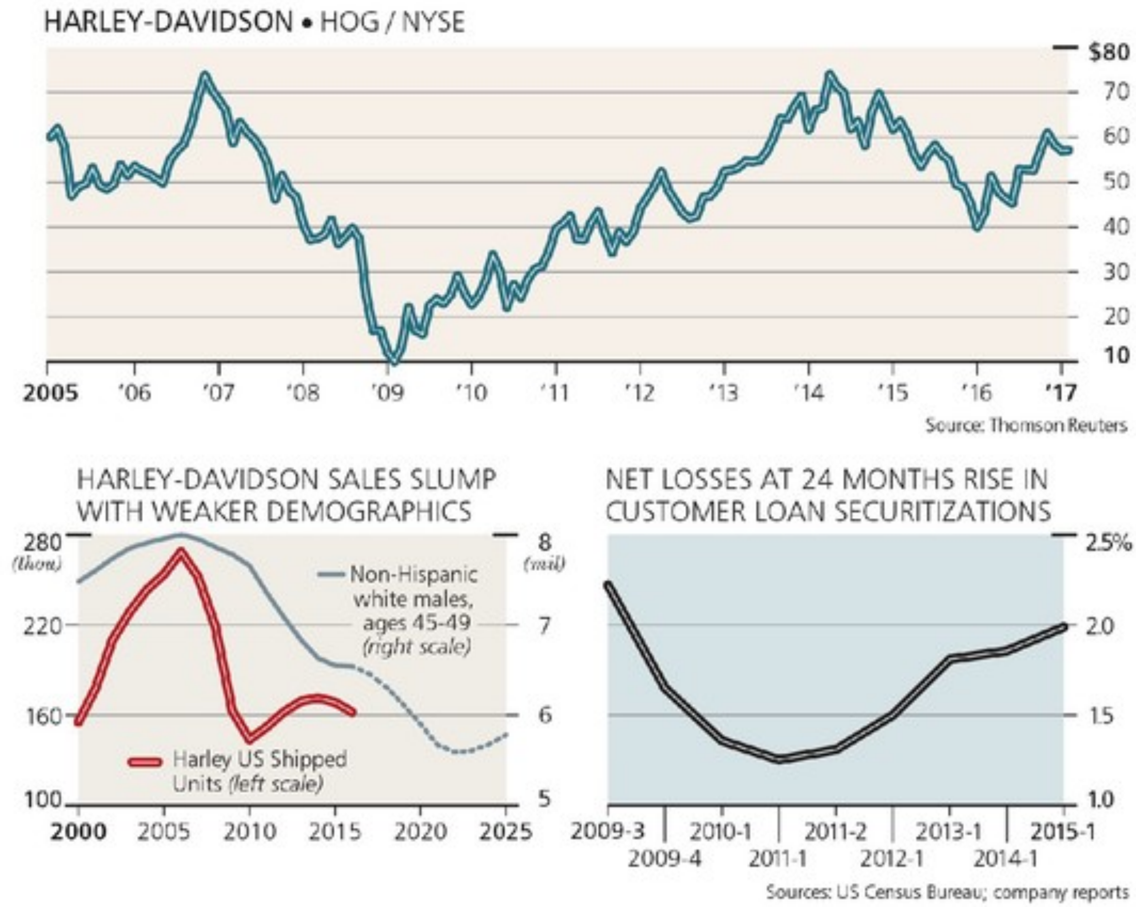
HARLEY HAS TRIED to tackle its demographic challenge head on, with "outreach" marketing to younger men, as well as women, African-Americans, and Hispanics. Its H-D Riding Academy program gave lessons to over 65,000 newbies last year. Levatich proudly notes that Harley has gained market share from its rivals in all of those groups. As a percentage of Harley sales, the outreach customers have risen from 34% in 2010 to 40% in 2016.

But with 60% of sales still dependent on those middle-age guys, Harley clearly has an uphill fight. In Wall Street surveys, the dealers report wildly uneven success at converting joyriders into buyers. Overall new motorcycle registrations in the on-road categories where Harley competes fell 6% last year, according to the Motorcycle Industry Council. Harley's dealers, for their part, posted a 4% drop in unit sales in the shrinking market.

With its valuable brand, Harley has traditionally refused to discount its bikes. So even as it struggles to maintain sales, the company's profit margins don't look much the worse for wear. It drives demand with marketing, new products, and, in a more subtle way, the blandishments of its Harley-Davidson Financial Services unit, which finances most dealers' channel inventory and 60% of retail motorcycle buyers.

LEADER OF A SHRINKING PACK

Harley-Davidson CEO Matt Levatich is focused on the next generation of hog owners—particularly in growing markets like Asia. However, he must contend with a decline in the number of middle-age white men, its core market, bottom left, and rising net losses on its securitized loans, bottom right.



That's where some of the strains in the business appear. Though the company's HDFS credit outfit is in solid shape overall, a small if steady deterioration in the quality of its loans may reflect the company's increasing struggle to find buyers. Some of that erosion in credit quality shows up in a place that Wall Street analysts rarely look: in the loans that Harley has taken off its books by securitizing them as asset-backed loan pools.

In Harley's year-end 2016 financial statement, its retail motorcycle loans registered their highest 30-day-plus delinquencies and annual loss rate since the post-recession year of 2010. Last year's profits at HDFS were pinched by a $40 million provision for retail-loan losses.

The steady rise in motorcycle-loan loss rates is also clear in Harley's off-balance-sheet loan pools. The chart at left compares the net loss rate on each year's pools at the 24-month point. From 2011 to 2015, the pools' various securities filings show that loss rates climbed to 2% from 1.25%.

Those net loss rates are reaching levels experienced in the last recession. The thing is, we're not in a recession.

Levatich insists that Harley doesn't try to use financing to drive sales and says the company's mix of prime and subprime borrowers hasn't shifted. He attributes the rise in net credit losses, in part, to a "normalization" of defaults back to prerecession levels. The losses are compounded by reduced recoveries when Harley sells the repossessed bikes. Prices for used Harleys have declined as rival Japanese motorcycle makers like Honda Motor (HMC) take advantage of the weak yen. Levatich adds that international buyers have disappeared from used-bike auctions.

One particular trouble spot for bike loans has been in Texas and other U.S. oil-producing states, where Harley gets 15% of its sales.

As it tried to clear out dealer inventories ahead of last summer's new products, Harley offered financing with low interest rates and little or no money down. Many of those loans were securitized in last year's June quarter, in a $300 million pool whose loans had a weighted average interest rate of 6.25%. The loans in prior-year pools had average interest rates of 11%.

And borrowers in last year's securitization have much less equity in their bikes. From 2011 to 2015, the proportion of loans in these deals with 10%-or-less down payments crept to 18.3% from 15.5%. In last year's pool, however, loans with low or no down payment came to 30%. Harley limited its financing incentives to prime borrowers, but securities filings show that in the few months since the securitization, loan losses are running ahead of the prior-year pools.

Despite the financial inducements to customers, last year's surfeit of used bikes weighed on trade-in values and hurt demand for new bikes. By the December quarter, there was such a backup of unsold units from model-year 2016 that the company had to curb its shipments of model-year-2017 product, including top-of-the-line touring models equipped with the new Milwaukee-Eight engine.

At some point, Harley will run out of room to ease credit as an offset to weak demand.

LEVATICH SUGGESTS that investors pay more attention to international sales, which have grown from 22% to 38% of unit sales in the past decade. Harley has three dealerships in Vietnam, where there are 42 million motorcycles on the road. "Thirty years ago, most of those were bicycles," says the CEO. As disposable income grows there—and in Indonesia, India, and China—Harley will be ready.

Investors may need some patience. The motorcycles typical of those regions are a fraction of the size and price of the high-margin beasts the company sells in developed countries. Levatich says the company has no interest in selling the kind of lightweight utility bikes that one sees on the streets of emerging markets. Most of those are sold by Japan's motorcycle makers—Honda, Yamaha Motor (7272.Japan), Suzuki Motor (7269.Japan), and Kawasaki Heavy Industries (7012.Japan). To stay competitive, Harley doesn't raise its prices in local currencies, so the strong dollar significantly reduces the profits it brings home.

Meanwhile the off-road and specialty vehicle leader Polaris Industries (PII) launched a line of bikes under the historic Indian brand, which is more squarely targeted at Harley's market. Polaris sold over 18,000 units in 2016.

That's a small fraction of Harley's sales, but in a shrinking market for big bikes, every Indian sold means one less new sale for Harley.

RUMORS OF A private-equity buyout gunned the shares last summer and have encouraged some analysts to perform sum-of-the-parts valuations, which tend to come in around $60 a share. That assumes a separate sale of Harley's finance unit at a handsome multiple. Such a split-up would be difficult, given how Harley needs to use retail financing as a way to move inventory. And as long as the company continues its finance activities, its covenants with its own lenders will sharply restrict how much debt a buyout deal could pile on.

With so many secular challenges, it's hard to understand why Harley shares are still cruising along at 15 times this year's earnings, near the high end of their valuation range. Wall Street's analysts are noticeably mixed in their views of the shares. After missing growth forecasts for several years running, the company's cautious guidance for 2017 is for flat-to-down sales. Harley is a one-of-a-kind business, but a modest rerating of its prospects—say, to 12 times 2017 earnings—could park the shares somewhere below $50.

"This is a 114-year-old company," says CEO Levatich. "We don't take a short-term view."

This week is the company's annual analyst meeting. We'll see whether investors share his view.

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