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Harley-Davidson's (HOG) CEO Matt Levatich on Q3 2019 Results - Earnings Call Transcript

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Q3: 10-22-19 Earnings Summary

Press Release *10-Q* *Slides*

EPS of $0.7 beats by $0.03 | Revenue of $1.07B (-4.89% Y/Y) beats by $25.05M

Earning Call Audio

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Harley-Davidson, Inc. (NYSE:HOG) Q3 2019 Earnings Conference Call October 22, 2019 9:00 AM ET

Company Participants

Shannon Burns - Director-Investor Relations

Matt Levatich - President and Chief Executive Officer

John Olin - Chief Financial Officer

Conference Call Participants

Joseph Altobello - Raymond James

Jaime Katz - Morningstar

David MacGregor - Longbow Research

Sharon Zackfia - William Blair

James Hardiman - Wedbush Securities

Craig Kennison - Baird

Billy Kovanis - Morgan Stanley

Tim Conder - Wells Fargo

Joseph Spak - RBC Capital Markets

Operator

Thank you for standing by and welcome to the 2019 Third Quarter Earnings Conference Call. At this time, all participants are in a listen-only mode. After the speakers' presentation, there will be a question-and-answer session. [Operator Instructions] Please be advised that today's conference is being recorded. [Operator Instructions]

I would now like to turn the conference over to your speaker today, Director of Investor Relations, Shannon Burns. Thank you. Please go ahead sir.

Shannon Burns

Good morning everyone. You can access the slides supporting this call at investor.harley-davidson.com. Click the earnings materials box in the center of the page. Our comments will include forward-looking statements that are subject to risks that could cause actual results to be materially different. Those risks include, among others, matters we have noted in our latest earnings release and filings with the SEC. Harley-Davidson disclaims any obligation to update information in this call.

Joining me this morning are President and CEO, Matt Levatich; and CFO, John Olin. Matt, let's get started.

Matt Levatich

Thanks, Shannon, and good morning, everyone. We've closed out our third quarter with results that included EPS and operating margin that were ahead of expectations and in addition, we made noteworthy progress which I'll get into here today.

As we shared in September, we've sharpened the focus of our objectives to build riders in the United States and made clear how we plan to invoke the power of our brand in new ways to deepen the commitment of riders now and into the future.

Our strategy and commitment to build riders is driving deeper understanding and broader capabilities that are and will continue to propel our company forward and our operating discipline along with our dealers' efforts continue to bring increasing business stability in this dynamic marketplace.

Guiding all our efforts is deeper analysis and insights on why people engage, participate and disengage from riding. Our advanced analytics capabilities and rider migration database have evolved into a powerful asset and a wealth of information and inspiration for us.

We know more than ever about how to attract people to riding and keep them engaged to build committed riders and we know how this applies, no matter what their experience level, age or life stage.

We have two primary focus areas, attracting more people to riding and keeping riders riding. Our execution might be different for young adult versus a returning rider. But the essence of our work is the same across the customer spectrum.

We are bringing precise focus to how we influence each customer at their decision points to build the total number of committed Harley-Davidson riders, where we've previously had an objective to build 2 million new riders in the U.S., we now know why, where, how and what we can do to work both sides of the equation attracting and retaining to increase the total number of riders.

We've done the math considering demographics in used bikes and we've set targets for new riders we need to attract and retention rates that we need to achieve 4 million total U.S. Harley-Davidson riders by 2027.

Reframing these objectives helps us sharpen our work on both increasing the pools of incoming riders and better activating passions of new and existing riders. This is an important refinement that underscores what we've said for several years now.

Our mission is about activating riding. The power of this refinement is in the focus that our entire enterprise has on building new riders and keeping all riders in the saddle and enjoying the ride.

In September, we also shared that we are directing investment, building capabilities and structuring the organization to activate the Harley-Davidson brand more powerfully. We are intensifying our rider-centric approach to spark passion that deepens rider commitment. In line with this focus, we've added Amplified Brand as a growth catalyst in the More Roads to Harley-Davidson's plan. Our brand efforts will bolster the existing growth catalyst of new products, broader access and stronger dealers.

We activated this additional growth catalyst during the quarter and started to embed it in all of our work. We are digging in and focusing investment to faster model culture and build an even bigger, more passionate community of Harley-Davidson riders across all aspects of the riding journey.

In Q3, our marketing spend was up over 30% and our efforts included LiveWire and LowRider S television spots running in major markets across the United States, which helped to generate over 700 million impressions.

We also continued rolling out a refreshed brand look at major events during the quarter including Sturgis, World Surf League and Spartan races and we announced we will be the presenting sponsor at next summer's hotly anticipated Hella Mega music experience tour featuring Green Day, Weezer and Fall Out Boy.

During the quarter, we also sharpened our objective to grow our international business to 50% of annual HDMC revenue by 2027. Previously the growth measure was motorcycle unit volume. As we see the opportunities we have for growth globally, unit volume of traditional products will be less a proxy for revenue that it has been in the past.

Revenue better captures all our efforts including things like e-bicycles, and a refreshed apparel approach. We remain very focused and optimistic about our growth prospects outside the United States. We have the research insights momentum and even sharper plans to create new pathways to Harley-Davidson and expand access and appeal for more people around the world.

Simply put, we are working to make riding matter more to more people and we are building on a position of strength. Never have there been more Harley-Davidson riders. In 2018, there were over 1.3 million in international markets and 3 million in the United States. Compared to 2010, in the U.S., we saw growth across all ages including young people.

In fact, contrary to some perceptions, the data shows a 1.5 times incident rate increase for 18 to 29 year olds in 2018 versus 2010. We know more about these riders than we ever have. A research helps us understand why and when people become riders and why and when along their riding journey they leave, which has informed our work to activate riders along the participation lifecycle.

Our insights inform not just our opportunity in the U.S., but the focus of our efforts around the globe. We see a significant opportunity to interact with tens of millions of people around the world who are curious about Harley-Davidson or interested in becoming a Harley-Davidson rider. As we strengthen our focus to attract new riders and deepen rider commitment, we’ve got more in our product pipeline than ever before.

We are also honing our research in international markets and will continue to use geographic and rider insights to drive targeted actions at the local and market level. In the slide deck, you will see a revised graphic that depicts the key structural elements of our strategy to build the next generation of Harley-Davidson riders.

As shown, the catalysts are interconnected and working in concert. To meet our objectives, we must successfully leverage all catalysts. A perfect example of this, an initiative that touches every aspect of our More Roads plan is our leadership in the electrification of motorcycles.

Our work to further Harley-Davidson and the industry is generating valuable learnings and cultivating capabilities that are both exercising the organization and propelling us forward. It’s tough and rewarding work and we are hungry for the challenge.

As I’ve mentioned before, our grit defines our culture as does our unrelenting drive to deliver for our riders. During the quarter, we crossed a historic threshold when the first LiveWire motorcycles made their way down our new production line at our facility in New

York, Pennsylvania. And today, LiveWire motorcycles are being produced and delivered to dealers and customers across the U.S. and Canada.

Leading in this new space requires agility, and a clear commitment to the first principles of quality and integrity and we are demonstrating both. We are deploying rigorous protocols for product quality and integrity and facing first mover challenges head on.

Since day one, it’s been essential that we set the bar for what high-performance, no excuses electric motor cycle should be and the media have all but crowned that achievement. We take pride in the rigorous quality standards and controls we employ in our drive to lead the industry and deliver the world’s best motorcycle.

We know our dealers and customers are eagerly awaiting LiveWire and we are ensuring it will exceed their expectations. LiveWire is an exceptional motorcycle. Our expectations for retail sales consider the premium nature of this product and the premium sets the bar for the industry and paves the way for the balance of our electric product portfolio we will introduce over the next several years.

A portfolio designed to appeal to customers who will enjoy the thrill and ease of 'twist-and-go' acceleration across a range of price points and design features suited to a variety of uses. We have something in our plan for almost everyone starting with three year olds.

And on that note, during the quarter, we delivered to our dealers the first IRONe electric-powered two-wheelers for kids, a result of our StaCyc acquisition earlier this year. The thrill of riding is now being appreciated by kids and their families. It’s incredible to witness and our U.S. dealers are powering up family fun activations.

This is a demonstration of our strategy, a comprehensive approach to build the next generation of Harley-Davidson riders.

As we attract new customers, we continue to reward existing riders and brand fans. In Q3, we also brought to market a terrific array of 2020 motorcycles and gear to ignite their passion. We are seeing strong demand for the Low Rider S and CVO Tri Glide and great response to the significant technology we added to class-leading model year 2020 motorcycles.

The team is laser-focused on building riders today and preparing us and our dealers to welcome a broader array of new riders moving forward.

Positive momentum in Q3 from our broader access and stronger dealers, initiatives was driven by a stronger mix of value-driving equity marketing as we dial in and dial back sales incentives and further improved capabilities such as dealer digital programs and lead management tools deployed across our dealer network.

Stronger dealers retail marketing and dealer operations consulting teams continue their onsite dealer visits and operations evaluations in the U.S. and international markets to assess and provide the tools and process support dealers need to take their business to the next level. Participating dealers are seeing improved results across many areas of their business including sales of new and used bikes, P&A and apparel.

In addition to product sales improvement, dealers who engage in operations consulting are seeing a 10% increase in service revenue compared to other dealers in their district and retail marketing consulting is driving a 20% average increase in unique website visits for participating dealers. We and our dealers continue the groundwork to be nimbler and more responsive to market and customer demands.

Our efforts in Q3 drove increased business stability with predictable performance in most areas of the business and we are encouraged by trends in retail sales results globally. We are confident our strategy and sharpened focus will drive even more positive results going forward.

In the U.S. and in all our markets, we continue to maximize value while we invest in future strength and growth. We are walking this line in all we do with keen awareness and focus. We will do more with the Harley-Davidson brand drive relevance, inspire ridership and make riding matter more to more people.

So with that, I will turn it over to John to discuss the financial results for the quarter. John?

John Olin

Thanks, Matt. In the third quarter, we were pleased to deliver EPS and Motorcycle segment operating margin ahead of expectations. The worldwide retail sales rate improved during the quarter versus the first half of 2019. We also made good progress as we continue to execute our More Roads with the Harley-Davidson plan to drive future growth.

The summary of our Q3 results is on Slide 13. In the third quarter, Motorcycle segment operating income was impacted by lower shipments, higher year-over-year tariffs and unfavorable mix partially offset by lower year-over-year SG&A and the benefit of our manufacturing optimization initiatives.

Financial services operating income was down 13.0%. Consolidated net income was down versus prior year due to lower operating income. EPS for the quarter was $0.55. When excluding restructuring plan cost and the impact of recent EU and China tariffs, adjusted EPS was $0.70.

We remained focused and disciplined on tightening retail inventory, aggressively managing costs, generating cash from operations, and delivering strong shareholder returns over the long-term.

On Slide 14, worldwide retail sales of new Harley-Davidson motorcycles in the third quarter were down 1.2% versus prior year. International retail sales were up 2.7% driven by growth in both our developed and emerging markets.

In the U.S., Q3 retail sales were down 3.6% versus prior year, which represents an improvement in the sales rate over recent quarters. Our retail sales benefited from our actions and the tempering of the industry’s retail sales declines. We expect our business to remain under pressure as the U.S. and developed international markets continue to face substantial headwinds.

The global competitive environment remains intense with aggressive promotional activity in the U.S., and worldwide new product introductions. We expect to overcome these market challenges by focusing on our intensified efforts to execute our More Roads plan and to build committed riders. We believe that we have a strong plan for the future and we are executing with great urgency.

Now let's take a closer look at the U.S. on Slide 15. In the U.S., Q3 retail sales were down behind lower, but improved industry retail sales performance and softer market share. Third quarter industry retail sales were down 1.7%. The industry's third quarter performance represents the lowest year-over-year rate of decline in the last fourteen consecutive quarters.

On a year-to-date basis, the industry was down 3.9% versus a decline of 8.7% during the same period last year. Similarly, Harley-Davidson's year-over-year retail sales rate of decline tempered in the third quarter as compared to recent quarters and was in line with our expectations. On a year-to-date basis, Harley-Davidson's retail sales decline of 5.6% compares favorably to last year's decline of 10.2%.

We believe this improved rate of decline was driven by improved industry performance, our focus on stronger dealer growth catalyst and increased marketing investments.

During the quarter, our market share of new bike registrations in the U.S. was 49.8%, down 1.1 percentage points and stronger performance in segments which we do not currently compete but plan to compete in by the end of next year as we execute our More Roads plan.

Harley-Davidson gained 2.2 percentage points of market share during the quarter within our Touring and Cruiser segments, which represents approximately 70% of the total 601 plus CC industry. In the second and third quarters, we increased the execution of our stronger dealer growth catalysts and increased brand marketing, while dialing back on our short-term focus sales incentives.

During the third quarter, we reduced our year-over-year sales incentives, but did offer a two week finance incentive on carryover motorcycles aimed to driving dealership traffic in conjunction with the arrival of our new Model Year motorcycles and to further reduce our dealers' carryover inventory. We tightly manage shipments of new motorcycles into the dealer network in the quarter.

This resulted in the quarter end U.S. retail inventories decreasing approximately 550 motorcycles versus prior year. We were pleased with the dealer inventory levels and the mix of our new product, our new model year bikes at the end of the quarter. We believe this market discipline is important in maintaining consumer and dealer value and will ultimately result in stronger retail sales of new motorcycles.

On Slide 16, third quarter international retails sales were up 2.7% versus prior year. Q3 retail sales were up in both our developed and in our emerging markets. Emerging markets retail sales were up 4.7% during the quarter led by growth in ASEAN markets. ASEAN markets benefited from reduced pricing, which was enabled by the elimination of tariffs due to supplying these markets from our plant in Thailand.

Strong growth in these markets was partially offset by softness in India and Mexico. Retail sales in developed markets were up 1.8% during the quarter. Our developed markets' Q3 retail sales rebounded from the second quarter, which was down 13.6%. During the quarter, we delivered solid retail sales growth in Australia, Canada, and Japan, which all have been down over the past several quarters.

We believe that strength in Japan was partially aided by an increase in the country's consumption tax which went into effect on October 1st. Western Europe retail sales were down slightly, but significantly improved from the decline in the second quarter.

Our year-to-date market share in Europe was 8.9%, down 1.5 percentage points versus prior year. Our market share was adversely impacted by lapping last year's strong Softail results and by lower sales of Street motorcycles due to the impact of implementing the Street recall. We remain confident in and committed to the great potential that exists in our international markets.

We believe our More Roads plan supports the strength of our brand, products and distribution to this – drives growth – sustainable growth internationally.

On Slide 17, wholesale motorcycle shipments in Q3 were down 5.8% and roughly at the midpoint of our guidance. Overall, family mix shifted from Touring to Cruiser Motorcycles versus last year's third quarter.

On Slide 18, revenue for the Motorcycles segment was down 4.9%, behind a 5.8% decrease in motorcycle shipments. Average motorcycle revenue per bike was essentially flat. A less rich product mix and unfavorable foreign currency exchange were offset by higher year-over-year pricing and reduced sales incentives.

Wholesale and MSRP weighted average pricing of our new model year 2020 motorcycles increased approximately 0.5%. Adjusting for the cost of the new content, pricing increased approximately 0.2 percentage points expressed as a percent of revenue.

On Slide 19, gross margin in Q3 was down as a result of lower shipments, product mix and unfavorable currency, partially offset by favorable manufacturing expense and slightly higher pricing. Product mix was unfavorable by $18.5 million in the quarter driven by family, model, P&A and general merchandize mix.

Q3 gross margin was adversely impacted by $3.8 million of unfavorable currency. Q3 revenue was down nearly 1 percentage point due to stronger U.S. dollar, which was largely offset by hedge gains.

In Q3, manufacturing expense was favorable versus prior year driven largely by savings resulting from the implementation of our manufacturing optimization initiatives, partially offset by lower absorption and lower production and shipments. In addition, Q3 tariffs impacts of $21.6 million were up $11.3 million versus prior year.

On Slide 20, operating margin as a percent of revenue for Q3 was lower compared to last year, driven by lower gross margin, partially offset by lower SG&A and restructuring expenses. SG&A was lower than prior year as we continue to aggressively manage cost and reinvest savings in our More Roads plan and in increased marketing investments.

Restructuring charges for the manufacturing optimization totaled $7.6 million in the third quarter, down $7.2 million from prior year. Profitability was strong. Profitability and cash flow remain a key focus. It is our objective to further leverage and build our capabilities to continue to drive profit, cash flow and top quartile motor company ROIC.

Financial Services segment third quarter operating income shown on Slide 21 was $72.9 million, down 13.0% compared to the prior year. Net interest income was up $1.1 million due to higher year-over-year receivables and favorable interest rate yields, largely offset by higher interest expense.

The provision for retail motorcycle loan losses was $11.4 million unfavorable in the quarter, driven by higher credit losses and an increase in Q3 2019 reserve rate compared to a decrease in the reserve rate in Q3 2018.

Operating expenses were up versus prior year as a result of a Q4 2018 reporting change in which Harley-Davidson Dealer Systems business moved from the Motorcycle segment to the Financial Services segment and due to higher depreciation as a result of our investment in a new loan management system, which was implemented in January 2019.

HDFS' operational results are on Slide 22. Q3 retail originations were up 0.8% versus prior year driven by an increase in used bike loan originations. HDFS' market share was 67.6%. At the end of the quarter, there was $380.3 million of cash and cash equivalents at HDFS and $1.33 billion of liquidity available through bank credit and conduit facilities. During Q3, HDFS paid dividends of $50 million to Harley-Davidson Inc.

On Slide 23, both our 30-day plus delinquencies and credit losses were adversely impacted as expected by startup inefficiencies resulting from the implementation of our new loan management system in the first quarter. In the fourth quarter, we expect the system implementations impact on key metrics to be largely behind us.

The 30-day delinquency rate for retail motorcycle loan receivables on balance sheet in Q3 was 3.75% or 15 basis points higher than last year's Q3 rate, but sequentially improved from Q2 2019, which was up 24 basis points. The annualized retail credit loss rate for receivables on balance sheet was 1.83%.

Q3's loss rate increase of 28 basis points was slightly above Q2 2019, which was up 26 basis points as it takes time for the increased delinquent loans resulting from the LMS system implementation to roll through to credit losses.

To a lesser extent, third quarter credit losses were also adversely impacted by softer motorcycle prices at auction. The remaining Harley-Davidson Inc. financial results are summarized on Slide 24. Our quarter end cash and marketable securities balance was $862.4 million. Year-to-date operating cash flow of $848.6 million was down versus last year, driven by higher working capital, and lower net income.

Regarding liquidity, the company has and intends to continue to maintain a minimum of 12 months of projected liquidity needs in cash and/or committed credit facilities. We believe the charts on Slide 25 demonstrate that we are a leader in ROIC at the Motor Company and ROE at HDFS, and we are a clear leader in our ability to generate and return cash to our shareholders.

One of the five objectives guiding our business strategies and execution through 2027 is to deliver superior return on invested capital as measured by Motor Company ROIC in the top quartile of the S&P 500 and by best-in-class return on equity at HDFS.

Slide 26 illustrates the recent history of returning cash to our shareholders. In the third quarter of 2019, we paid a quarterly dividend of $0.375 per share and repurchased 112.5 million of our stock. Driving superior value for our shareholders is a top priority. We have a robust and disciplined process for our investment decisions.

We look for opportunities to grow value through investments that maximize the performance and long-term potential of the company and the brand. After investing in our business, we intend to return excess cash to our shareholders in the form of increasing dividends and share repurchases.

Slide 27 is a summary of our multiyear manufacturing optimization. Annual ongoing cash savings are expected to be $65 million to $75 million after 2020. We continue to expect $25 million to $30 million in savings for 2019 and we realized $16.7 million of these savings in the third quarter.

For the full year, we continue to expect to incur $40 million to $50 million of operating expense. Manufacturing optimization costs were $10.0 million in Q3. We believe these investments have very attractive returns. They simplify our manufacturing footprint, provide focus in our operational investments and expect to improve gross margin by roughly one and a quarter percentage points.

Moving on, our 2019 full year guidance on Slide 28 remains unchanged from Q2 with the exception of the 2019 capital spending. We now expect capital spending to be $205 million to $225 million, which is $20 million lower than our previous guidance.

On the yields of last quarter's approval by the EU to allow favorable tariff treatment of our Softail and Sportster motorcycles produced in our Thailand facility, we remain on track to begin producing motorcycles in Thailand by the end of October for sale in the EU allowing time for transportation and flow through of high tariff inventory, we continue to expect to begin mitigating EU tariffs in early Q2 of 2020.

For the full year 2019, we now expect impacts of recent EU and China tariffs to be approximately $105 million. This is a $5 million increase from prior expectations and is driven by an increase in Section 301 tariffs, which remained very fluid as they continue to shift with global trade negotiations.

For 2020, we now expect annualized 301 tariff impacts to be approximately $20 million. We are currently evaluating alternatives to help mitigate the impacts of these new tariffs. In the fourth quarter, we expect to ship approximately 38,500 to 43,500 motorcycles.

Also in the fourth quarter, we expect motorcycle operating margin as a percent of revenue to be a loss of approximately 5.5% representing an improvement over last year's fourth quarter margin.

Fourth quarter results are expected to be adversely impacted by lower shipments, unfavorable mix, approximately $14 million of higher year-over-year tariff costs and unfavorable currency, partially offset by favorable SG&A behind lapping Q4 2018 recalls.

To wrap up, during the quarter, we progressed against our More Roads to Harley-Davidson plan that addresses today's marketplace challenges and the tremendous opportunities that exists in our international markets.

As we look through the remainder of 2019, we are encouraged by the momentum of retail sales trends through the first nine months of this year but also recognize the substantial headwinds that we continue to face. Looking longer-term, we are prepared for an extremely dynamic and highly competitive global marketplace. We are committed to driving long-term growth for the company and strong returns for our shareholders.

Thank you. And now, let's take your questions.

Question-and-Answer Session

Operator

[Operator Instructions] And your first question comes from the line of Joe Altobello from Raymond James. Go ahead please. Your line is open.

Joseph Altobello

Thanks. Hey guys. Good morning. So, first question, I want to delve into the international retail improvement. Obviously, pretty significant quarter-over-quarter and you talked about some of the drivers of that in Japan, the consumption tax for example. But want to get a better sense for what drove the improvement in Europe and Canada beyond that.

John Olin

Okay, Joe. This is John. With regards to the improvement that we saw quarter-over-quarter, one very – I am very pleased with it. Second quarter, we had the developed markets down 13.6% and they were up 1.8%.

All developed markets improved on a quarter-over-quarter basis. Canada, Australia, and Japan all posted pretty strong gains on a year-over-year basis and that's a first time in several quarters that they've been up year-over-year and Western Europe, while it was down slightly, still had some significant improvement.

As we look across all of them, we've talked about stronger dealer efforts, which started about five or six quarters ago in the United States. We've been looking to fast the depots' efforts into our international markets.

And you are seeing some of that come through in the third quarter. So, Joe, for example, on the dealer sales incentives, we changed our dealer sales incentives in the United States about four quarters ago, just changed them in the third quarter internationally. Much more simplified dealers certainly got a lot more clarity as what they are doing on retail sales and we believe that benefited.

Second aspect is, we really fell off, the dealer network fell off a little bit on the demo rides and test rides that they were doing. We got that was back on track in the third quarter. And then finally, similar to the United States, as we look to amplify the brand, we increased our brand equity marketing in international markets in the third quarter, as well.

Joseph Altobello

That's very helpful, John. Thank you. And then just one quick follow-up, in terms of the operating margin outlook, you mentioned fourth quarter minus 5.5% but that's a GAAP number. I think on an adjusted basis, you are probably looking at something – if you are looking at a full year 10% margin, fourth quarter adjusted operating margins are likely going to be up modestly, is that the case?

John Olin

They will be improved. I don't have that number in front of us. Basically, it peel out the tariffs which are going to be up incrementally $14 million, as well as the year-over-year manufacturing optimization spending. I don't have that number in front of me, Joe.

Joseph Altobello

Okay. Perfect. Thank you guys.

Operator

Your next question comes from the line of Jaime Katz from Morningstar. Go ahead please. Your line is open.

Jaime Katz

Hi, good morning. I am curious if you guys have factored the promotional environment into your outlook for the full year. I mean, if you have and what impact it might have on the ability to capture rising prices and revenues in the quarter ahead and into next year? Thanks.

Matt Levatich

Hi, Jaime. If I am understanding the question, first of all, we are in a higher promotional environment today. As we look quarter-over-quarter, we believe that about half of our competitors have increased amount of promotional activity from last year to this year. And at the same time, they are doing that, we are starting to back off of somewhat we would call sales incentives.

And that's promotional offers and finance offers. And so, again, when we look at the results that we posted in the United States in Q3, while they were down, that certainly tempered, but that was in the phase of pulling back on some of the sales incentives that we had been offering. They are actually down about 50% in the third quarter.

As we look across the full year, we are continuing to look to shift money from sales incentive into more brand equity-based and more sustainable marketing.

Jaime Katz

Okay. And then, I think in the prepared remarks, there were some comments that there was an expectation of retail sales for LiveWire. Would you care to share that with us?

Matt Levatich

I don't think there was, Jaime. We do not provide model level shipment or retail sales data. What we did on LiveWire is we began shipping in the last week of September. And so we had some shipments, but on the 40,000 units or so that we shipped is very minor and we are just very excited to have LiveWire in the market and starting to deliver to our customers.

Jaime Katz

Thank you.

Operator

[Operator Instructions] Your next question comes from the line of David MacGregor from Longbow Research. Go ahead please. Your line is open.

David MacGregor

Yes, good morning everyone. John, the question was on HDFS and just you are looking at an increase in your provisioning, I think it was $11 million increase in provisioning and you talked about financing promotions and it sounds like maybe you are dialing these back a talked about financing promotions and it sounds like maybe you are dialing those back a little bit now.

But can you talk about the extent to which the provision increases were a function of the financing promotions versus maybe other factors and to what extent do you expect that provisioning to pullback now that maybe you are easing back on the promotions?

John Olin

Thanks, David. We don't – there is – we don't believe that there is anything with regards to the finance offers driving those higher provisions. So what you are referring to is in the quarter, we had an increased provision of $11.4 million and that was driven by about half of that is driven by higher credit losses and we talked about that for the last several quarters.

The majority of that is being driven by the LMS system implementation and the startup that we had and as we've got things going, we expect those to be largely behind us. But in the third quarter, the majority of that was driven by the LMS. The other half of it simply is the provisioning in the reserves on a year-over-year basis and we look at those reserves are made up of two things.

One is the reserves that we have booked this year and those are slightly higher in the third quarter. But the biggest piece of the reserves is what happened in the 2018 third quarter is we actually reduced reserves by a fair amount and so we are just lapping that.

So that provision is made up of two pieces, credit losses as well as the reserves about half and half. There is not a significant impact due to the promotions that we've had or the finance offers that we've made.

David MacGregor

Thank you.

Operator

Your next question comes from the line of Sharon Zackfia from William Blair. Go ahead please. Your line is open.

Sharon Zackfia

Hi, good morning. John, I wanted to ask a question about the motorcycle operating margin in the quarter. I think, originally you have guided for it to be about 300 basis points and it was kind of down half of that. So, could you give us some color on what the price of the positive on the motorcycle margins?

John Olin

Great and thanks for the question, Sharon. I love to share this one with you. You are absolutely right. It came in about 1.5 points favorable and that's largely driven by lower SG&A and to that reason and why I say I am glad you asked it is, our employees have done an absolutely fantastic job of becoming more efficient evaluating every dollar that they spend and as we've talked about for quite some time is we are looking to fund our More Roads investment internally.

And so, while we've got those costs rising on More Roads, as well as our Amplifying the Brand, we've increased marketing, as Matt had mentioned over 30% in the quarter. All of that was paid for by our employees doing their jobs and doing them more efficiently every day. So, we couldn't be more pleased with that.

And so, that came in higher than what we expected and on the quarter basis, SG&A was lower by about a $1.5 million, again, absorbing all the cost with our More Roads and a 30% increase in marketing expending. We couldn't be more thrilled with that performance.

Sharon Zackfia

Okay. Thank you.

Operator

Your next question comes from the line of James Hardiman from Wedbush Securities. Go ahead please. Your line is open.

James Hardiman

Hey, good morning. Thanks for taking my question. So, some of my questions are answered, but I wanted to maybe circle back on one of the – somewhat – one of the questions I've got a lot coming out of the Analyst Day and that's how to think about gross margins in 2020. Just as a point of clarification, I think you guys mentioned that with some of the new middle weight bikes, gross margins would be down. But, am I wrong in saying, that's on a pro forma basis excluding tariffs. But that, when we factor in the tariffs gross margins should still be up next year. And maybe just lay out – you mentioned some stuff in the prepared remarks about tariffs this year and next. Maybe just give us the best estimate right now based on the timetable of when you are going to be up and running in Thailand and shipping into the EU. Just how much of a tariff benefit should we expect in 2020?

John Olin

Okay, James. First of all, we have not provided a guidance on gross margin in 2020 and the middle weights will not have a significant impact in 2020, because they will come out later in the year. We will provide more guidance on operating margin next quarter.

But in general, we've said over the next three year period of time, or through 2022 is that, we would face some gross margin headwinds because of the new products that we're coming out with – that are coming out at very strong margins.

But just not at the same level as the products that we've been delivering for 116 years in our Touring and Cruiser bikes. And with that headwind, some of that will be offset by the absorption and the higher growth that we expect coming out of those investments. But then overall, operating margin would increase through the period of – or through 2022 as we further leverage SG&A.

So, that's what's been said about gross margin. When we talk about tariffs, and I had mentioned in the prepared remarks is that, tariffs are expected to be a $105 million this year. And that's made up of three component pieces. Approximately $90 million of that change is EU tariffs, right? And with that, we expect to mitigate the vast majority of them.

There is a couple models that we will continue to ship from the United States. But that will come in early in the second quarter. So, the timing is, is that we will start producing in late October in Thailand. There is time on the water. It will arrive in the EU market at the end of

2019, in the beginning of 2020. We need time to burn off the existing inventory.

We are taking down production right now and limiting as much inventory of the high tariff bikes as we can into the market. The low tariff bikes will enter into the market in early January, late this year and will flow through the system and we believe by early second quarter, we will begin mitigating the tariffs in Europe.

So on a year-over-year basis, it will be the $90 million less what we are able to – we will still have tariffs in the first quarter.

The second component of it is, tariffs of shipments that we've had from the United States into China, that represents this year about $7 million. Those bikes are currently being produced in Thailand today and being shipped into China today.

And we are a little bit earlier in the cycle than we are in EU and right now we are burning off the high tariff inventory into the bikes in China and by the beginning of the year, we would expect to be able to mitigate the vast majority of that $7 million of tariffs by the very beginning of 2020. And then the third component is about $8 million of 301 tariffs.

And this is the component that's increased from last quarter to this quarter and that's the advent of List 4 that went into effect on September 1st and the expectation of List 4A and another List 4 set of products becoming implemented in the middle of December. Again, this is very volatile and it's what we know today and it seem to change quite often.

But given the timing of when these are, we would expect List 4 products to be approximately $20 million in 2020. And so, that would be an incremental increase in those tariffs by about $12 million, James. And we are looking to mitigate those through – largely through resourcing the products.

James Hardiman

That's really helpful. Thanks guys.

Operator

Your next question comes from the line of Craig Kennison with Baird. Go ahead please. Your line is open.

Your line is open.

Craig Kennison

Thanks. Just a quick two-part question. First on James's question. As it relates to the EU tariff and then $90 million this year, should we just take one quarter of that and apply it into next year? And then, Matt, as it relates to the U.S. economy today, what's your view on things? Unemployment is low, but recession periods are rising. I am curious what your take is overall.

John Olin

I'll answer the first part, Craig. With regards to the first quarter, we are going to be in the neighborhood of that. We will provide more granularity at the end of January when we do our call and we will see the inventories, what ended up in market and so on and so forth. But by and large, we are early into the second quarter is when those tariffs would be mitigated.

Matt Levatich

Okay, Craig, it's Matt. Yes, thanks for the question. If I had that crystal ball, I would be utilizing it on a daily basis. I think the market continues, whether you are talking at the corporate level or the consumer level to face quite a bit of uncertainty regarding all manner of sort of economic stability related to the tariffs and obviously the political Presidential campaign and so forth.

But having said that, sitting here right now, I don't think that that uncertainty is higher than it was six months ago and in fact, seeing the industry pick up that we saw in the third quarter is obviously an encouraging sign.

I would just say that, from a company perspective, we are looking at our business with the abundance of caution necessary in an environment like this and that underscores how pleased we are with the increased predictability and performance to plan that we see in our business.

We've done a nice job really dialing in our measures and our dashboard of how things are moving, keeping inventory very tight, being very nimble in production and shipments, recognizing that we are in probably the most uncertain forward environment that we've recognizing that we are in probably the most uncertain forward environment that we've been in, in a long time. And we'll continue to do that.

That's the focus, because we can't predict the future anymore than anyone else can. All we can do is be as nimble and responsive as possible. And I think we are well positioned to do that. So thanks.

Craig Kennison

Thank you.

Operator

Your next question comes from the line of Adam Jonas from Morgan Stanley. Go ahead please. Your line is open.

Billy Kovanis

Hi, this is Billy Kovanis for Adam Jonas. A question on HDFS. In the quarter, it looked it B2 motorcycle operating margins was offset by HDFS, with HDFS margins down year-over-year despite pretty supportive credit conditions?

What management changes aside and accounting changes aside? Could you please comment on how HDFS may have been impacted by assets on new riders? Is it reasonable to assume as a slight sacrifice in credit quality in HDFS in order to drive some revenue growth? Thanks.

John Olin

I am sorry. My mike was off. So, when we talk about the quality of the company's portfolio, Billy, is we couldn't be more pleased with where the portfolio is. We've got a very strong portfolio and it's performing very well aside from the LMS issues that we've talked about. And I think when you talk about credit quality, what you are referring to, I would assume is a subprime as a percentage of the total.

And we've been in a range of 15% to 20% of our loans are subprime. And this year, we are seeing subprime up a little bit on a year-over-year basis still and well within that range and I guess, actually in 2018, we saw subprime down about the same amount. So it kind of goes up and down. But I would caution to equate that subprime is a bad thing.

As a matter of fact, subprime is a very good thing. It does push up some of the credit losses and credit metrics and delinquencies. But that is a shift in mix. When we look at subprime, those loans have a tremendously high return on equity or very profitable and they also come with, in most cases, an incremental motorcycle sale.

Because there is no other lender of subprime motorcycle customers in the United States. And so, we are very judicious about it and we have been keeping again in that 15% to 20% channel. But the answer to your question, we couldn’t feel better about the loan portfolio that we have aside from the issues that kind of the ripple effect to the LMS.

Billy Kovanis

That’s very helpful. Thank you.

Operator

Your next question comes from the line of Tim Conder from Wells Fargo Securities. Go ahead please. Your line is open.

Tim Conder

Thank you. And John, I would like to just follow-up on that question a little bit. We do get a lot of questions related to the HDFS. So, I guess, another way to ask it is, are you seeing the trends in the credit metrics, if you split prime and subprime and you talk about the mix, but as far as the actual credit losses, how are those trending?

Or would you all be looking in the future to maybe kind of break the disclosures of those losses out between prime and subprime? Just any color if you could give us there

. And then, the other follow-up would be the third quarter retail cadence in the U.S. in particular, just to clarify, was July – did those benefit from the promotions I think that were done by yourselves and the industry and then how did August and September look year-over-year relative to the month of July year-over-year? Thank you.

John Olin

Thanks, Tim. With regards to the splits between prime and subprime and you look at the higher credit losses that we have at higher delinquencies, I think you might find it little counterintuitive is, this year, we are seeing a larger increase in prime or a denigration in prime that we are subprime. And again, the LMS system is driving that.

But we keep a close eye on – of those that are very segmented to us and we use different drivers to improve them. But again, overall, the metrics that we are seeing are driven by the LMS. Prime is a little bit worse than subprime and we are working with that and expect also that to drop off by the fourth quarter.

Your next question, Tim, was with regards to the sales cadence within the third quarter. I think to understand the sales cadence of the third quarter is really to look at what happened in the third quarter of 2018 and it's really the mere opposite of it.

But as we walk through it in the month of July, retail sales were up in the United States in the low-single-digits. In August, they were down in the mid-single-digits and in September, they were down in the mid to upper-single-digits.

With regards to the promotional activity in July, we had very little promotional activity in 2019 in the month of July. We had very little promotional activity in the third quarter, net effect the biggest thing that we did in terms of sales incentive in the third quarter was a two week finance offer in September, net compared to the year ago period of a six week finance offer across Touring and Softail.

This year, we did two weeks on just Touring and we did that again, get people to come into the dealerships with the arrivals of the new model year motorcycles, as well as help our dealers with carryover inventory. And as I have mentioned, carryover inventory is in very good shape. It's the best that it's been in many years.

But also looking to help the dealers because there is very little price increase on a year-over-year basis that help them move out some of the excess carryover.

Tim Conder

Great. Thank you. Very helpful.

Operator

Your next question comes from the line of Joseph Spak with RBC Capital Markets. Go ahead please. Your line is open.

Joseph Spak

Thanks, good morning. John, just maybe a clarification, because, on the second quarter call, you talked about the incremental tariff headwind for this year being lower to $100 million. Now it seems like you are saying, it’s actually $80 million with the incremental $40 million.

And then, we look at sort of what was already done year-to-date. The gross margin guidance is always sort of just down year-over-year and that remains, but it also seems like that’s lower, you have some savings progress. So, is there another change we should think about in the gross margin?

John Olin

I am not completely tracking with you, Joe. In the second quarter, we are expecting approximately $100 million of tariffs this year that wasn’t an incremental year-over-year, that’s what we were expecting this year. We did incur some tariffs in 2018. So the incremental piece is lower than $100 million.

We’ve increased that from a $100 million to $105 million and then we talked about what’s going to happen in 2019 – I am sorry, in 2020. EU tariffs will start to fall off in the second quarter. China tariffs will fall off at the beginning of the year and the 301s are going to be with us until we can mitigate those. If you can give me a little bit more, I can help out, but that’s…

Joseph Spak

Yes, no, maybe it’s just sort of bad or a misspeak. But if I go back to the second quarter transcript, the tariffs you talked about on an incremental basis being $100 million. So your answer sort of clarified that. Maybe in lieu of that if I could just ask just one on HDFS.

I guess, just maybe you could just give us some color about how you think about the return on some of the actions you are taken the issue of as holistically, because I know it's sort of not a perfect metric here, but if you look at sort of what's happened to HDFS income plus motorcycle gross profit, that is sort of still down.

So, I mean, how do you think about the incremental return from using HDFS a little bit more to stimulate sales?

John Olin

Yes, I think if you go back and look at overall margins, going back several years ago, they were higher. And I believe they are higher for all financial service companies and the reason being is that, coming out of the downturn, we saw customers are really focused on repairing their credit. In addition and a bigger driver was that we have all the recoveries.

Once we write-off alone, we never stop going after recovering it and so out of the downturn for several years after that, there was a lot of recoveries coming in and credit loan losses were at historically low levels and they have risen since then, one, because consumer behavior is changing and two is, just because they were at such a low level to begin with.

So, we have seen overall operating margins on fall. We've also seen on the cost of debt going up. It was very low last three or four years ago and it's starting to rise a little bit. But when we look at the returns, which we measure ourselves on return on equity of HDFS, and Joe, it's never been higher. It's at 22% last year and that is an absolutely extraordinary return on equity for any financial service firms.

Banking is a - good return is a little bit over 10. So, we are in a class of our own in terms of the returns that we are delivering from HDFS and couldn't be prouder in what that organization has done and the power of the brand to deliver those returns.

Joseph Spak

Thank you.

Operator

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And with that, I would like to turn the call back over to Mr. Shannon Burns for some concluding remarks.

Shannon Burns

All right. Thanks, everyone. The audio and slides for today's call will be available at harley-davidson.com, or for the audio, call 855-859-2056 or 404-537-3406 until November 5th. The ID is 9498744. We appreciate your investment in Harley-Davidson. Have a fantastic day.

Operator

Ladies and gentlemen, this does conclude today's conference call. We thank you for your participation. You may now disconnect.