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Vroom at the Top

Harley-Davidson has hit some bumps, but there's plenty of reason to stay high on the hogs

By JAY PALMER

REGARDLESS OF WHETHER it was drug-dealing Peter Fonda and Dennis Hopper riding to their doom in *Easy Rider*, or Marlon Brando and Lee Marvin leading rival beer-swilling gangs on a rampage in *The Wild One*, the popular image of a motorcycle rider -- especially one astride the **Harley-Davidson** machines favored by groups like the Hell's Angels -- once wasn't that great. But that picture is now more myth than menace. Today's rider isn't likely to be a troublemaker. Instead, he's probably a sedate suburbanite or city dweller out for a fun ride, or a middle-aged baby boomer trying to recapture his -- or her -- youth.

But a fun ride isn't what Harley stock has provided lately. Even as the company's powerful Fat Boys, Electra Glides and Road Kings have become mainstream and fashionable, the shares have suffered their own version of road rash, the tearing wounds riders get from sliding along tarmac in a motorcycle spill. Today, at around 51, after more or less missing the past year's rally, the stock trades no higher than it did in late 2001.

Gone is the rich stock-market premium Harley once enjoyed. In the five years to 2002, Harley's price-earnings multiple consistently was 30% to 75% above that of the Standard & Poor's 500. Now, on the basis of forecasts that 2004 earnings will be up about 11%, to \$2.77 a share, the stock's P/E is 18, about equal to the broad market's. It sells at a discount if you buy into the bulls' forecasts that earnings could rise as high as \$2.88 this year and \$3.33 in 2005.

The market's gloom is quite a comedown for this country's biggest motorcycle maker. Unlike the revived Indian brand, which collapsed into bankruptcy last year, the 'Eighties rebirth of Milwaukee-based Harley was managed better, admittedly with the help of now-extinct Reagan tariffs on the largest Japanese bikes. Then, as now, Harley was best-known for its big 1,450 cubic-centimeter touring and custom bikes, the classic "hogs," which account for more than 75% of its sales. The rest come primarily from its newer, smaller, less expensive HD Sportster and Buell lines, aimed at bringing "new blood into the family," says CEO Jeff Bleustein,



AP Photo/Pablo Martinez Monsivais

CEO Jeff Bleustein

But Harley's icon status hasn't stopped the bears from arguing that the stock is fully valued. They cite the company's performance in the final quarter of 2003, its 100th anniversary year. Over the full 12 months, sales jumped 13%, to \$4.6 billion, lifting net 31%, to \$761 million or \$2.50 a share. But in the final three months, profit was up a more modest 21%. While that's hardly horrible, the slower pace of gain fueled other concerns.

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Naysayers focus on October-through-December unit sales, which slid 7% from 2002 levels at a time when

overall U.S. motorcycle sales edged up slightly. The problem was that, to a greater degree than at any other time in recent history, Harley didn't sell almost everything it made. Against deliveries of 64,000 bikes, dealers moved only 41,000 to customers, leaving 23,000 in inventories. A year earlier, the surplus was a more normal 10,000. Result: Some dealers started offering price cuts of as much as \$3,500 on a \$20,000 machine, or financing with no down payment and 0% interest, to move the metal. While hardly unusual in the auto market and not uncommon for some Japanese motorcycles, such incentives have long been rare for Harley-Davidson. Indeed, the norm has been for buyers to wait months for machines and, after taking delivery, to find they could sell their new toys for thousands of dollars more than what they paid.

This year hasn't started much better, according to J.P. Morgan. A survey in early March of what the investment bank views as 40 of Harley's main dealers showed "demand is mixed." While some sellers still reported a waiting list, others were offering incentives. And, for the second consecutive year, prices of used Harleys were slipping.

All this appears to be grim news for the company, whose strong growth has been based on its longstanding ability to hold production and supply below demand. That strategy has fostered a steady increase in retail prices and robust profit margins. The latest numbers cast uncertainty over the company's plan to boost production 8% a year through 2007. Bears carp that this not only is unrealistic but, even if it occurs, would still leave production growth below the 10% of 2003, the 12% of 2002 or the 15% seen in several earlier years.

There are also worries about Harley's demographics.

Over the past few years, the age of a typical Harley buyer has risen to about 46 or 47, older than the industry's 38 or so. Given the graying of the wealthy baby boomers, the bears argue, the company faces a chilling long-term prospect: Its main customers are hurtling toward a future in which they'll be too old to take anything other than a wheelchair for a spin. **Table: Temporary Potholes?**¹

Harley is addressing this point with new Buell and Sportster bikes that sell in the \$5,000 to \$7,000 price range, well below the \$15,000 that a Fat Boy costs or the \$25,000 that a fully-equipped custom job can go for. The jury's still out on whether the lesser bikes will be a hit. Even if they do lure younger buyers away from the sport and off-road bikes of **Honda**, Suzuki, Kawasaki and Yamaha, critics warn, the combination of lower prices and added marketing costs will dent Harley's profit margins.

Despite these concerns, the worries seem overdone. Indeed, there's reason to argue that Harley stock could once again roar to the head of the pack, although maybe not as far ahead as it once was.

"It's unrealistic to expect the stock to get back to the point that it is selling at 75% above the market multiple," suggests Tim Conder, a leisure analyst with A.G. Edwards in St. Louis. "But a 30% premium, even 40%, wouldn't be undeserved." That implies a stock price, relative to the current market, of 65 to 70, and a handsome potential gain.

Some top institutional investors recently have been snapping up the stock. Among them is the Oakmark Fund. Says Kevin Grant, its co-manager: "We see a very high-quality company with a very strong consumer brand franchise that has earnings growing at better than 15% a year selling at a discount to the market."



The bulls argue that the bear case is now fully in the market, especially since the latest numbers from the International Strategy & Investment Group, a research firm, show that short positions in the shares would take a hefty (at least for Harley) seven day's trading volume to cover. They also say that both the slower fourth-quarter sales growth and the increase in the number of unsold bikes is temporary, caused by a normal and understandable slump following the hoopla over Harley's 100th anniversary last Labor Day.

"If you were thinking of buying a touring bike made by Harley-Davidson,"

Conder maintains, "then it's likely you would have bought earlier in the year, so you could participate in one of the many mass bike rides that were held across the country. That would have moved sales into the first three quarters from both the fourth quarter of last year, and maybe even the first quarter of this one."

Says Bleustein: "Our model year was extended to 14 months for the anniversary, so there was a higher-than-usual proportion of prior-year models at the dealers as we closed the annual reporting period. We see no indication at all that our long-term increasing rate of production has exceeded the long-term growth in demand. Once spring comes, the backlog will move." He says that sales merely are moving to a normal level, from a period of abnormally expansive growth.

The colder and wetter winter months of December through March always see a drop in demand, and any survey of dealers in this period isn't likely to be especially bullish. Conder will run his own survey in early April. His preliminary, spot discussions with dealers, he says, point to a much brighter future.

"The incentives are few and far between, and apply, almost entirely, as far as I can tell, only to older '03 models," he says. "I'm expecting a strong spring pickup, driven by improving weather, some bigger tax refunds and some good comparisons over the comparable period of 2003, when demand was impacted by war worries and the wettest season in the north-east in a century." His conclusion: "A stronger election-year economy and stock market will bring out more baby boomers eager to buy themselves adult toys."

(Friday, Dow Jones Newswires reported that a Lehman Brothers survey of nine Harley dealers in Cleveland and St. Louis showed that their businesses had picked up recently and that all expect a strong spring selling season. Four were selling bikes at premiums ranging from \$500 to \$2,000, depending on model, while the others were charging the manufacturer's suggested retail price.)

The aging of Harley's customer base also may be over-hyped. While some boomers are nearing 60, people now stay a lot more active for more years than their forebears did. In addition, most members of this post-war generation are in their 40s or 50s and still have lots of motor-cycling ahead of them.

Another big plus: Women, who once accounted for a mere 2% of Harley's sales, now make up about 9%, and this market is likely to expand further. (Catalyst, an advocacy group for women executives, recently cited Harley for fostering opportunities for women in the workplace.)

In any case, when the baby-boom generation does pass into geriatric sloth, it will be about time for their kids, Gen-Y, to start thinking about buying a big bike. The less expensive machines will bring new customers, and greater overall volume should limit the hit from lower average margins.

And Harley has a solid financial base to build on. Both its return on assets (17.3%) and return on equity (29.3%) remain well above the market averages, and it has almost no debt (except for its finance division). Cash flow is prodigious -- more than \$930 million a year -- funding not only R&D and production but also stock buybacks, a stream of annual dividend increases going back a decade and a rich war chest of more than \$1.3 billion, equal to about \$4.40 a share.

As the economic recovery gathers strength, Harley sales are likely to do the same. "Earnings will grow in the

HARLEYS

From Classic to Light



Top to bottom: Electra Glide; Fat Boy; Sportster 1200; Buell Firebolt

mid-teens for years to come," promises Bleustein. That would mute the bear's worries, return the stock to a premium and give investors a nice ride.

A year from now, investors in the Fat Boy's maker could be in fat city again.

E-mail comments to editors@barrons.com²

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