IDEA MECHANIC REPORT

Harley-Davidson

Overview

Harley-Davidson, Inc. (NYSE: HOG) will announce its Q3 earnings tomorrow morning and its earnings-per-share will likely be rosy. Harley-Davidson pushed a new line of bikes out to the dealers and Q3 is the last quarter of the year that includes sunny good motorcycle-buying weather for the US and Canada. Also, in Q3 Harley-Davidson most likely continued to buy its own stock. So, even though Harley-Davidson just recalled over 29,000 motorcycles due to clutch issues, it is likely that it will squeeze out a good earnings call.

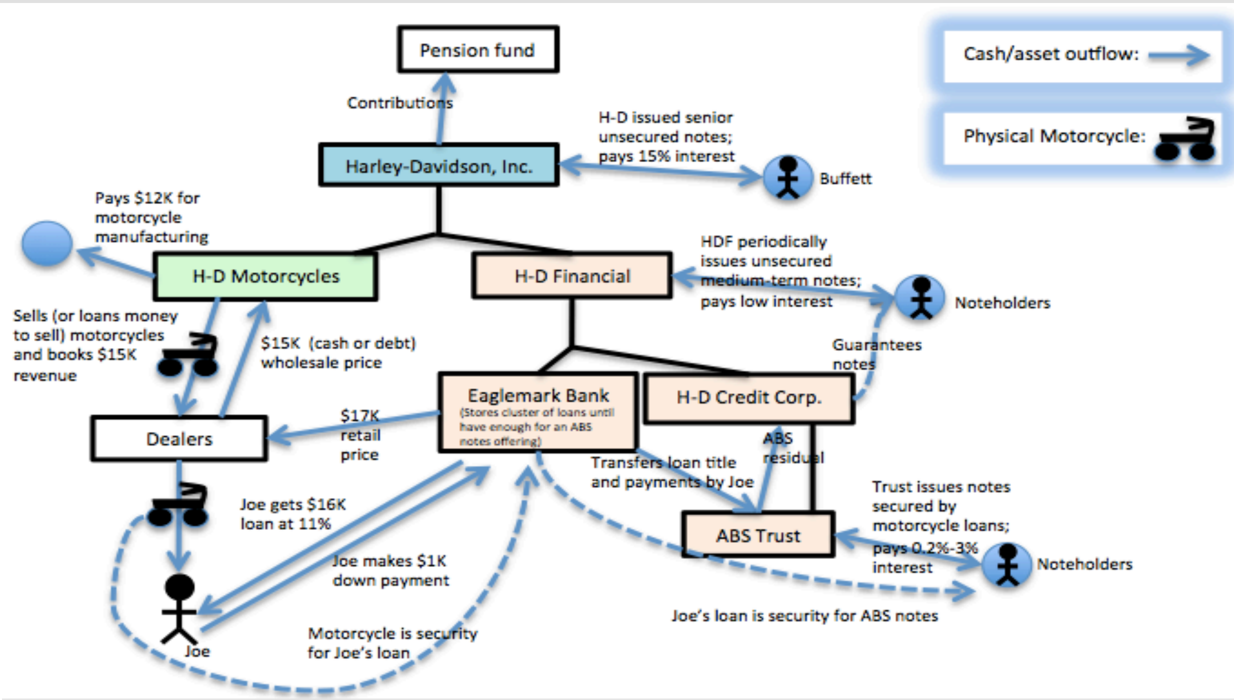
But don't be fooled. This might be Harley-Davidson's last good quarter. Ever.

Of course, everyone knows that Harley-Davidson could fade slowly as the customer base for clunky and loud motorcycles dies off. (There are only so many American white guys that were adults in the '60s and '70s, when Harleys might have been considered cool, that are still spry enough to ride motorcycles…). But that's not going to be the downfall of Harley-Davidson. What Harley-Davidson is facing now is a GMAC-like plummet. And here, the government 'aint coming to the rescue.

Harley-Davidson Financial Services is Bleeding Like a Stuck…

As background, below is a diagram of a typical motorcycle purchase when Harley-Davidson Financial Services ("H-D Financial") provides the financing for the motorcycle. This occurs in about half of the sales in the US.

Example Harley-Davidson Cash Flow Diagram



[1] The hypothetical figures in this diagram are derived from Harley-Davidson's SEC filings and are intended to represent an average H-D financed transaction. Motorcycles may retail for more than $17,000 on average, but the excess is estimated to primarily go to the dealer, not Harley-Davidson.

As demonstrated in the diagram above, the margins for a financed transaction are most likely higher than the margins for a non-financed transaction. This appears to have created problems for H-D Financial.

Here are some red flags:

Harley-Davidson has the opportunity to use the ABS facilities to create the appearance of liquidity elsewhere in the company. In 2009, Harley-Davidson started reclassifying its finance receivables because it was intending to[2] start consolidating the ABS facilities into its financial statements. Then, in 2010, the ABS facilities were fully consolidated and significant changes were instantly reflected in their financials. For example, the earnings per share more than tripled.

Harley-Davidson Credit Corp. ("H-D Credit") services the ABS facilities and is a subsidiary of H-D Financial. At least since 2011, H-D Credit has been able to do whatever it wants with the ABS cash, including blend it with Harley-Davidson's cash. This blending can happen every day of the year, except once a month when there is a monthly payment to the ABS noteholders.[3]

Also noteworthy is the recent change in how Harley-Davidson has repaid its ABS noteholders. From 2004 (when Harley-Davidson started securitizing its motorcycle loans) through 2009, the ABS noteholders were repaid sometime during the March after the facility was entered into. So the ABS facilities were approximately one year (or less) facilities. All the prior facilities were cleared off the (unconsolidated) books in March.

Since 2010, the facilities have lingered. Currently, all of the ABS facilities since and including the 2010-1 facility are still being repaid. That is a lot of money and debt that is sloshing around the company each month, creating the appearance of actual cash on hand.

There is insufficient evidence that H-D Financial's motorcycle loans are fully diligenced. Eaglemark Bank is essentially the only entity with the full information about the likelihood of the repayment of the underlying motorcycle loans. But, the 'diligence' that they do is essentially obtaining a FICO score. That's it. Everything else relating to the disclosure in the

Harley-Davidson does not guarantee these loans, so the only recourse for the ABS noteholders is to foreclose on the underlying motorcycle loans themselves. Likewise, there is a short-term incentive for H-D Financial to inflate the quality of the underlying motorcycle loans, obtain a low interest rate on the ABS notes, use the ABS cash to maintain the appearance of liquidity throughout the company and obtain other debt at a very low interest rate.

The ABS assets are being used, quietly, to guarantee the company's medium-term notes. H-D Financial periodically issues medium-term notes. These notes are guaranteed by H-D Credit, which in turn 'commingles' its assets with the ABS facilities' assets most of the time (aside from one or two days a month). Thus, H-D Credit is putting the ABS facility's assets at risk, but not disclosing this in the ABS facility offering documents. According to the ABS facility offering documents, the ABS noteholders should only incur the risk of default by the underlying motorcycle loanholders, not the risk of default by H-D Financial on its medium-term notes. Furthermore, if this upstream guarantee were fully disclosed in the ABS offering documents, the interest rates on the ABS facilities would likely be higher.

Recent disclosure about the issuance of medium-term notes has been egregiously delayed and incomplete. The medium-term notes discussed above are also incompletely disclosed. The company has acknowledged the materiality of the medium-term notes, and yet the company typically only files an Officer's

[2] See p.35 of the 2009 10-K.

[3] Starting in 2011, a new 'commingling' risk factor turned up in the ABS offering documents. It says that H-D Credit may hold in its own account the collections on the underlying motorcycle loans up until the day before a distribution is to be made to the ABS noteholders, which is generally on the 15th of the month (or the next business day).

Certificate on Form 8-K that indicates that an issuance has been made.

Furthermore, most recently, the company did not even file an 8-K at all. The first announcement of the terms of the last-minute Q3 2012 issuance of $600 million of medium-term notes came in the company's 10-Q for the period. The 10-Q was filed on November 8, 2012, *months* after the September 2012 issuance. This appears to be an 8-K violation, in addition to a red flag about how the company is managing its finances near the end of each quarter.

The motorcycle segment is propping up the financial segment. In addition to the red flags discussed above, a major red flag has appeared in the last couple of years. Starting in Q2 2011, *the motorcycle segment has been propping up the financial segment* by issuing the following short-term loans that straddle the end of a quarter:

2011:

- $200 million term loan to H-D Financial; incurred in Q2 and repaid in Q3.

2012:

- $200 million term loan to H-D Financial; incurred in Q2 and repaid in Q3 (July).
- $400 million term loan to H-D Financial; incurred in Q4 and repaid in Q1 2013 (January).

2013:

- $300 million term loan to H-D Financial; incurred in Q1 and repaid in Q2 (April).
- $300 million term loan to H-D Financial; incurred in Q2 and will mature in 2014.

(And to make things worse – H-D Financial can't even immediately repay its most recent loan.)

Cash is being thrown at H-D Financial and then disappearing. Even after borrowing cash from the motorcycle segment, issuing medium-term notes issuances, issuing ABS notes, and commingling the ABS assets with the general Harley-Davidson assets, H-D Financial's cash is disappearing.

On September 30, 2012, the financial services segment had its best recent showing of cash and cash equivalents: $747 million. This is understandable considering that during Q3 of 2012, the financial services segment raised $675 million from selling ABS notes and $600 million from issuing medium-term notes.

On December 31, 2012, the financial services segment had only $340 million of cash and cash equivalents; and during Q4 of 2012, the financial services segment took out a loan of $300 million from the motorcycle segment.

On March 31, 2013, the financial services segment only had $346 million of cash and cash equivalents, even after the motorcycle segment lent it $300 million during Q1.

And it gets worse. On June 30, 2013, the financial services segment only had $366 million of cash and cash equivalents. During Q2 of 2013 it raised $650 million from issuing ABS notes and it borrowed $300 million from the motorcycle segment. Where did the cash go?

Harley-Davidson's debt repayment obligations will worsen in early 2014. In addition to its normal rolling debt and interest payments, Harley-Davidson will need to repay Warren Buffett $300 million in February 2014. Buffett holds the approximately $300 million of Harley-Davidson's senior unsecured notes that are still outstanding.

The company's debt/cash flow issues could consume the company. The key to understanding the significance of H-D Financial's problems is appreciating the scale of the company's ABS facilities and its debt obligations. On December 31, 2012, Harley-Davidson had $294 million of short-term debt and $4.4 billion of long-term debt. The counterbalance to this debt is the company's operating income from its motorcycle segment. At December 31, 2012, this operating income was $715 million, and at December 31, 2011, this operating income was $561 million.

Customers are complaining about Harley-Davidson's financial services. It is not hard to find very unhappy Harley owners that have wrestled with H-D Financial. Some owners are angered by H-D Financial's inability to provide a confirmation that a loan has been fully repaid until a month or two after such a request. Others have been harassed by debt collection services even after the motorcycle was repossessed. Additionally, some people have fought with Harley-Davidson's insurance company after it refused to pay claims after accidents. It would not be surprising if H-D Financial faces increasing scrutiny from customers and regulators going forward.

Other Signs Point to Uh-Oh

If H-D Financial were the only issue with the company, then maybe Harley-Davidson would have a fighting chance. But, H-D Financial is the hole in a boat in a lake that is drying up. Either because of the hole or the dropping waterline, this boat isn't going to be floating much longer.

Below is a brief summary of some of the other issues facing the company.

Buffett is leaving. The company's stock price has been on a bull run since Buffett invested in the company in February 2009. But Buffett will be moving on when his notes are repaid in February 2014.

The company can't repurchase its stock forever. The company has been helping its stock price and its earnings-per-share by purchasing its own stock and maintaining a 'Harley-Davidson common stock' fund as part of its employee retirement plan.

The stock price will eventually decline because, among other things, the company's fundamentals are unsound and the company is running out of cash. When the stock price declines, the company will immediately have less value on its balance sheet and it will need to find another way to bolster the company's retirement funds that have minimum value requirements.

Interest rates are only going to get worse. Currently, Harley-Davidson can borrow money extremely cheaply. The interest rate on its ABS notes has lowered to 0.2%-3%. It also has the benefit of investment grade pricing on its medium-term notes. After it pays off its 15% senior unsecured notes in February 2014, it won't be possible to find much additional savings from improving its credit rating. There is little room for debt to get cheaper.

Additionally, when interest rates eventually rise market-wide or for Harley-Davidson specifically, H-D Financial won't be able to pass along the increased cost to the customer. H-D Financial's motorcycle loans already top out at 25% interest. This high-end cap can't go much higher without getting crossways with loan sharking regulations. The cost of increasing interest rates will need to be absorbed by the company.

The company needs to improve its disclosure. If the company is going to mend its investor confidence, it will need to start disclosing the following:

- All material debt issuances on Form 8-K and a detailed description of the use of the proceeds from such offerings.
- Cash flow within the quarter, particularly with respect to the commingling of ABS facility assets and Harley-Davidson's assets.
- The definition of 'cash equivalents' and the amount of straight cash, as opposed to cash equivalents. (Does 'cash equivalents' really include 3-month receivables, but not exclude 3-month payables?)
- Terms of the company's loans to its dealers.
- Amount and nature of the loans that are kept on the books of the company and not 'transferred' into an ABS facility.
- Amount of stock being transferred to the company by employees for tax contributions (in lieu of the more standard deduction from one's salary).

- A description of the bike repossession process and customer complaints that have arisen.
- Statistics about the motorcycle market that are more helpful. Motorcycle registration statistics are not a good measure of the size of the industry.

The Harley brand is suffering. It is well known that Harley-Davidson's customer base is shrinking. The people that still think Harleys are cool are typically underemployed white males that were adults in the '60s or '70s. These dudes are simply dying off. And sometimes the motorcycles themselves are accelerating this process.

Other brands have demonstrated that it is really hard to survive under these circumstances. Billabong and Birkenstock are examples of other 'fringe lifestyle brands' that have continued to struggle.

Competition is also increasing in the heavyweight motorcycle industry, and Harley-Davidson has neither the culture nor the know-how to innovate its product to make it more competitive.

Furthermore, considering H-D Financial's recent desperation, the company will need to figure out a way to manage its increasingly common characterization as a pawn shop with a clean showroom, but dirty tactics.

Harley-Davidson will face increasing regulatory pressure. Motorcycles are unsafe. Very unsafe. The industry has fought helmet laws, but is losing this fight, like the cigarette companies lost their fight. Motorcycle-accident medical bills are very expensive, so it is only a matter of time before unnecessary risks are prevented. And new safety regulations will further erode Harley's small remaining 'coolness' factor. It's just not as satisfying to jump on a Harley and then…strap on a huge bulky State-mandated helmet and follow the procedures you learned in your State-mandated safety training course. But that's soon going to be the reality.

Additionally, in the wake of the housing crisis, loan-sharking regulations are getting more stringent and they may cut into Harley-Davidson's margins.

Furthermore, by design, Harley motorcycles are loud and dirty, so the company will need to figure out a way to navigate a regulatory environment that is cleaner and less noisy.

The Pope doesn't approve. Clearly, not everyone is Catholic. But, when the Pope complains about your brand, it's probably not good for business. Pope Francis was given a Harley motorcycle in June by a group of Harley-Davidson owners. He responded by cautioning that "power and pleasure", among other things, lead to God being "replaced by fleeting human idols which offer the intoxication of a flash of freedom, but in the end bring new forms of slavery and death." (The bike will be auctioned to raise money for a hostel and soup kitchen in Rome.)

Costs have already been cut, so there's no wiggle room there. Harley-Davidson went through a crisis in 2008 when the ABS market dried up, so it has already done some emergency restructuring and slashed costs. In recent years, manufacturing was both relocated and outsourced. The company also cut employees and negotiated with the union regarding retirement benefits. There simply isn't anywhere else the company can go on the cost-cutting front. In fact, arguably the company already cut too many costs. It just recently recalled over 29,000 bikes due to clutch issues.

All of the issues are interconnected so one misstep can bring everything down. What must keep Harley-Davidson employees up at night is the potential domino affect of one problem within the company. Everything is very interconnected. For example, if the stock price declines, mandatory pension contributions will increase; this will affect cash flow, the ability to initiate loans and issue ABS notes, which will make the company much less liquid. Illiquidity will affect the company's rating and make debt more expensive. And the problems accelerate from there.

If interest rates rise or motorcycle sales decline, the same series of events will transpire. A slip-up anywhere in the company could have catastrophic consequences.

The Way Forward

If Harley-Davidson has a future, it needs to do the following things:

- Fix H-D Finance, even if it triggers a lower company rating and higher borrowing costs. If H-D Finance isn't fixed, the whole company will implode.

- Rebuild investor confidence by improving disclosure.

- Anticipate a shrinking customer base and expand aggressively into South America (one of the few growth areas).

- Plan to grow into a new line of business. For example, guns. Might as well keep Harley dangerous.

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