



## Stock Pick of the Week: Harley Davidson, Inc. (HOG)

If you have driven long enough, chances are you have seen (and probably heard) a H.O.G chapter taking over the street. There are 1400 of these dedicated chapters spread across the world, all sharing the affection for one product: a motorcycle. With over 1 million club members, these enthusiasts are a part of the largest company-sponsored riding club in the world. What motorcycle manufacturer can possibly garner such support and admiration? The answer is the subject of this week's stock pick of the week: Harley-Davidson (HOG)

### What is Harley Davidson?

Harley-Davidson, founded in 1903, manufactures cruiser and touring motorcycles for distribution around the world. The company operates in two segments, Financial Services, and Motorcycles and Related Products. The financial services segment provides financing and insurance programs for dealers and customers while the Motorcycles and Related Products segment, which comprises 90% of 2014 revenues, manufactures, and sells motorcycles to retail consumers.

### Why Invest Now?

The Harley Davidson brand remains as strong as ever and shows no signs of stopping. In 2014, 167,000 of the 313,600 new U.S. heavyweight motorcycle registrations were Harley-Davidson. This gives Harley a 53% share of the heavyweight motorcycle market, which happens to be Harley's main product category. Market share has been stable over the past five years, in a time when other motorcycle manufacturers have struggled, a testament to the company's strong appeal and customer base.

Aside from growth in the United States, Harley is seeing strong growth from its international markets as well. Sales from all international regions grew 5% in 2014 year over year, with particular strength from the Asia Pacific region, which grew by 12% year over year.

Due in part to the company's strong brand and image, it has been able to achieve consistent profit growth. Since weathering the recession in 2008, Harley Davidson has grown after tax profit ([NOPAT](#)) by 17% compounded annually. Over the same time frame, Harley has also increased in return on invested capital ([ROIC](#)) to 22%, up from only 13% in 2009. Harley-Davidson also generated [free cash flow](#) over \$900 million in 2014.

### What About Competition?

Investors have become concerned over competition and lack of volume growth within the United States. Concerns regarding competition are nothing new to the firm and the longstanding growth of the company is a great indicator of their ability to meet these challenges. Brand loyalty to Harley-Davidson remains intact. Over 1 million Harley-Davidson owners within 1400 H.O.G chapters mentioned earlier attest to this fact.

To address the low volume growth concern, Harley-Davidson has begun expansion plans to international markets such as Europe and China. This strategy, as mentioned earlier, has been very effective. Harley-Davidson continues to see growth in both Europe and China that surpasses its growth in America.

### Adjustments to Operating Profitability and Valuation

We make several key adjustments to the earnings and balance sheets of companies to uncover the recurring cash flows of each company's core business and the value left for shareholders. We made the following major adjustments to Harley-Davidson's earnings in 2014:

- Added \$2 million in [non-operating income](#) hidden in operating earnings.
- Added \$18 million to NOPAT due to [change in reserves](#).

When considering Harley-Davidson's valuation, we also added \$47 million in off-balance sheet debt (<1% of HOG's market cap) to Harley-Davidson's total debt. This adjustment brings Harley-Davidson's total long and short term debt to just under \$5 billion, or ~40% of market cap.



### **Buying Opportunity**

Foreign competition and slowing volume growth in America may be attributed to the stagnant stock price of Harley Davidson over the past three months. With the price declining around 3%, the opportunity to buy presents itself.

If Harley-Davidson can [grow NOPAT by 8% compounded annually for the next ten years](#), the stock is worth \$73/share today – a 20% upside. This growth would also represent less than half the average NOPAT growth of the last five years, highlighting the upside potential in Harley-Davidson.

*Disclosure: David Trainer and Allen Jackson receive no compensation to write about any specific stock, style, or theme.*

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