



# Steven Gorelik

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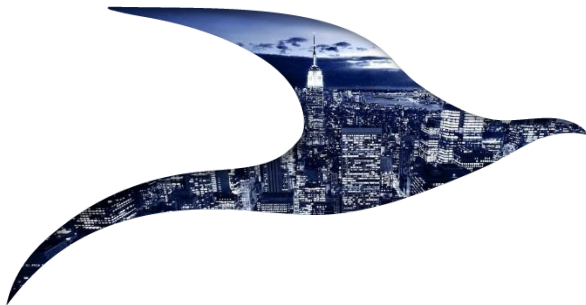
Wide Moat Investing Summit 2018 –  
Harley Davidson (NYSE: HOG)

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# Firebird U.S. Value Investment Approach

## Quality

We invest in companies with strong moats

- What is the source of competitive advantage?
- What is the value proposition to all stakeholders?

## Value

Cash flow focus

- Look at how the company generates and uses its cash
- Consider value derived from actual returns to investors (dividends + buybacks)

## Macro

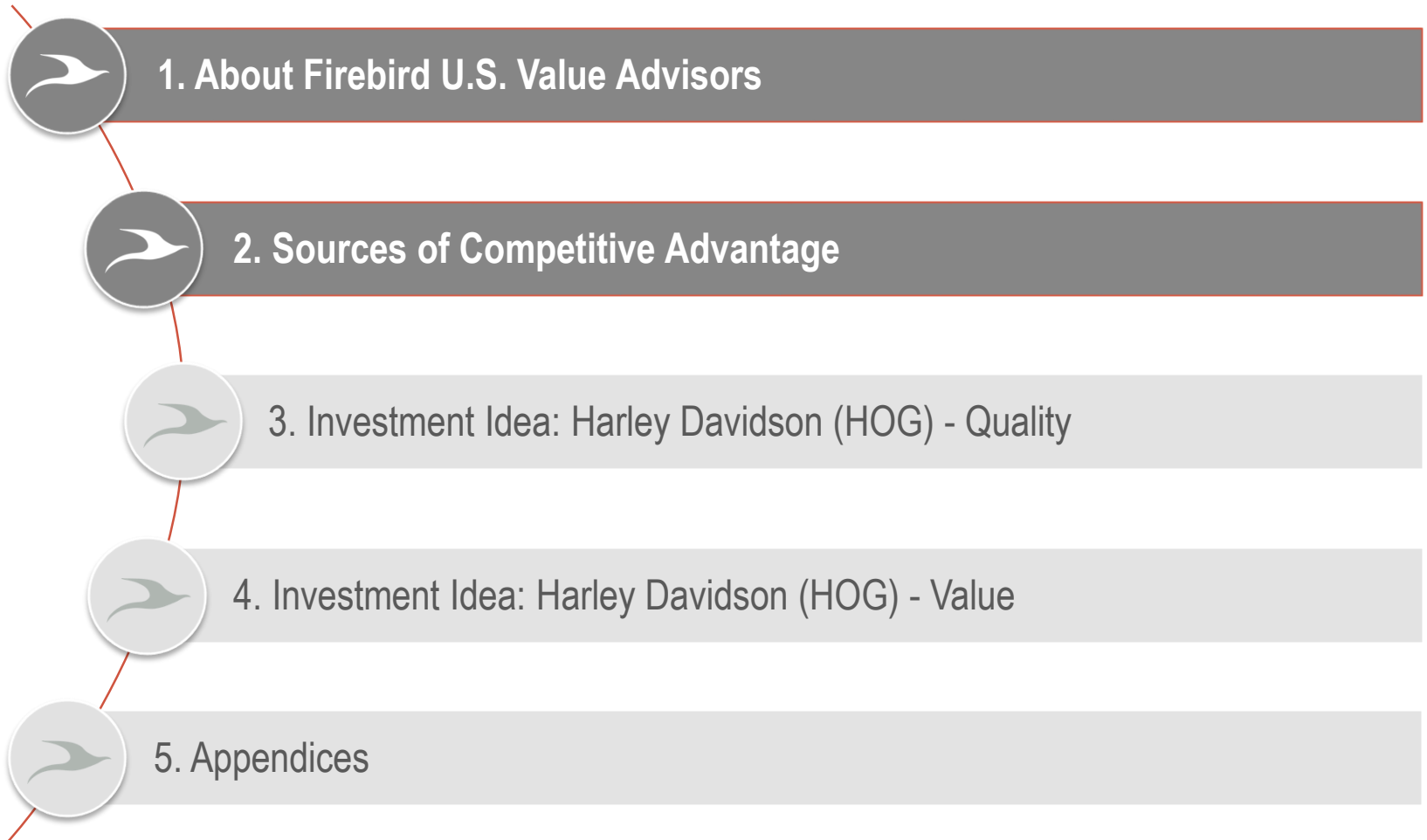
Macroeconomic analysis helps avoid value traps

- 20+ years of emerging market investing experience
- We don't simply "put-up with macro economics"

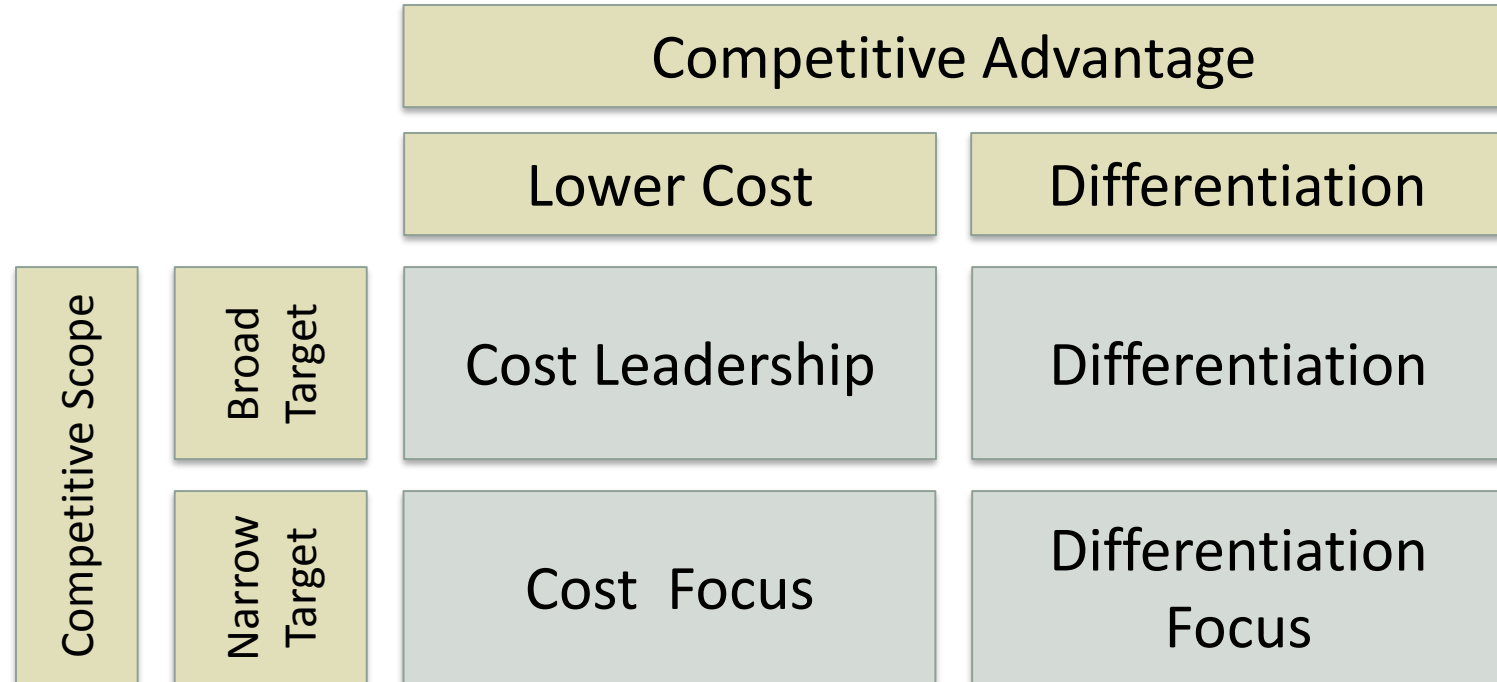


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# Porter's Framework

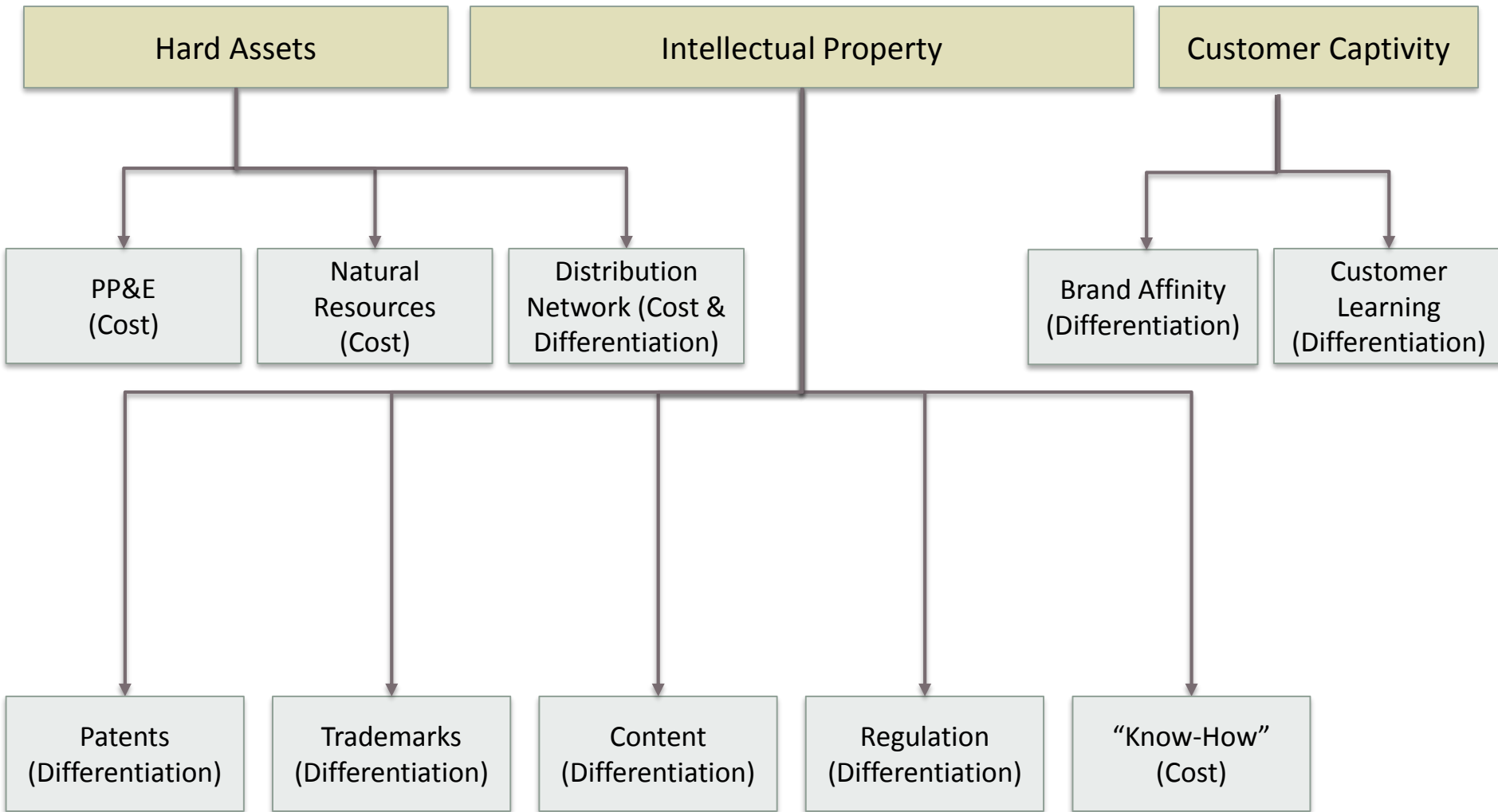


There are two basic types of competitive advantage a firm can possess: **low cost or differentiation**. The two basic types of competitive advantage combined with the scope of activities for which a firm seeks to achieve them, lead to three generic strategies for achieving above average performance in an industry: cost leadership, differentiation, and focus.

– Michael Porter “Competitive Advantage”



# Sources of Competitive Advantage



# Qualitative Analysis

## Key Questions:

- Does the company earn excess return on capital employed?
- What is the source of the “moat” driving excess profitability? Is it still in place?

Competitive advantage Framework	Hard Asset Based			Intellectual Property				Customer Captivity		
	PP&E	Natural Resource	Distribution/Scale	Patents	Trademarks	Content	Know-How	Regulation	Brand Affinity	Customer Learning
Key question	<i>Is it possible to create similar product without these hard assets?</i>	<i>Are superior resources leading to cost advantage?</i>	<i>Does company have a cost advantage due to its scale?</i>	<i>Are products protected by patents from copycats</i>	<i>Are products protected by trademarks from copycats</i>	<i>Does company create own content?</i>	<i>Does experience matter?</i>	<i>Does regulation limit new entrants?</i>	<i>Would customers pay more for this product simply because of brand?</i>	<i>Did customers spend time or money in order to get the most out of this product?</i>

- Do customers and suppliers benefit from company’s existence?
- Is the competitive landscape conducive to efficient competition? Is anything changing?
- Are there threats to the existing profitability? Are they secular or temporary?
- What is the main macroeconomic factor contributing to recent business performance?
- Does management invest in maintaining the “moat” or engage in empire building?
- What does the management do with excess cash generated by the business? Has management or its attitudes towards shareholder returns changed?



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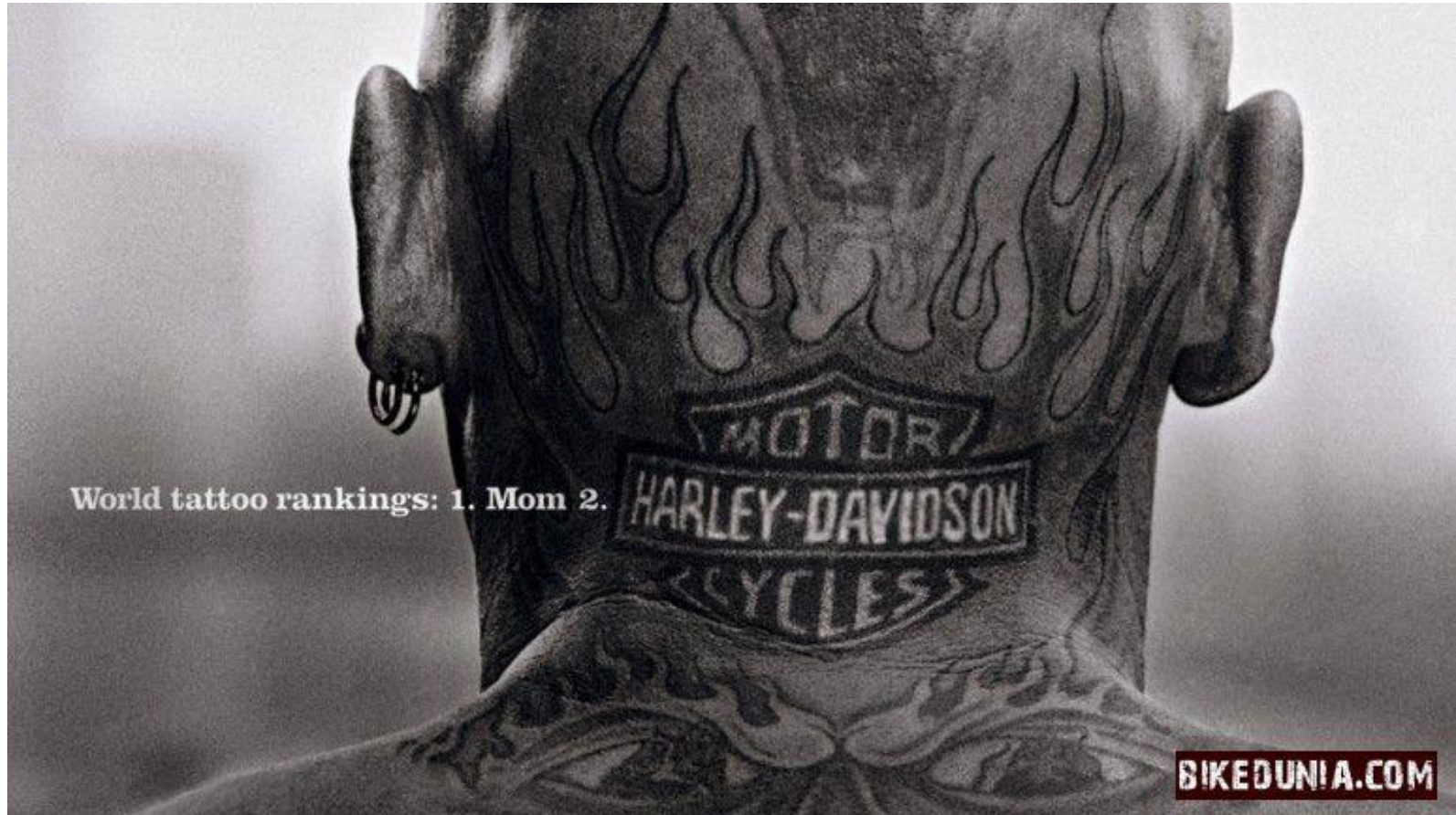
# Harley Davidson Overview

- Founded in 1903
- Name synonymous with America, motorcycles and the open road
- One of the most recognizable global brands
- ~50% market share in North American large (601cc+) motorcycles
- Two great businesses wrapped into one:
  - HDFS - Finance arm with sustainable 23% ROE
  - Motorcycle manufacturing and sales - ~100% ROIC
- Most of the free cash flow is returned to shareholders
  - Over \$5.5B in dividends and buybacks since 2011 – 77% of current market cap



# Harley Davidson Brand Recognition

- One of the few brands that people are willing to tattoo on themselves



# Harley Davidson – Sustaining Competitive Advantage

- Customers buy lifestyle, not just a bike
  - Brand value is constantly reinforced through licensing and cross-branding
  - Harley is investing in riding academy - building next generation of riders
  - \$170m+ of R&D per annum – 3% of sales

Significant floor space in each dealership is devoted to apparel



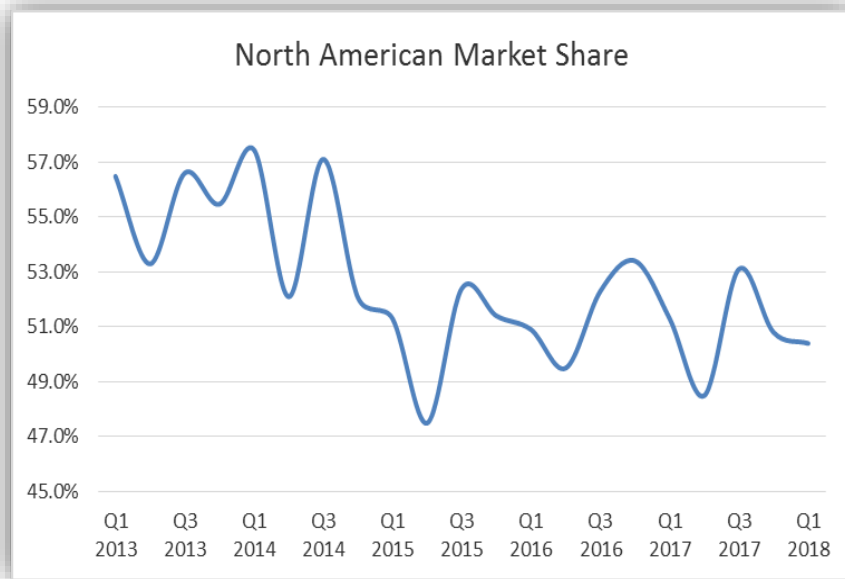
TV Shows/Movies such as Sons of Anarchy reinforce brand appeal



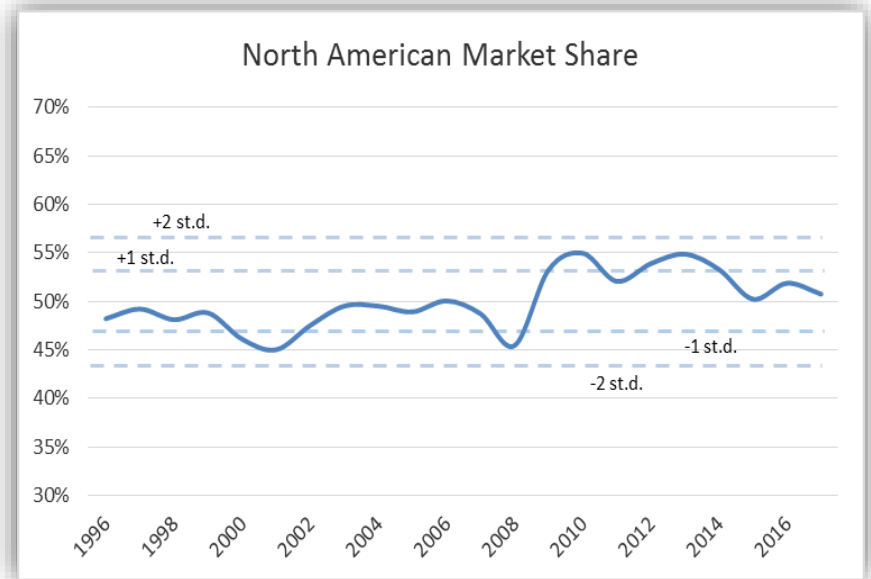
# Harley Davidson Market Share

- HD consistently sells 1 out of 2 large bikes in North America
  - Dominant market share drives superior margins and ROIC
  - Analysts focusing on quarterly moves in market share are missing the big picture
    - Current market share moves are less than 1 standard deviation away from historical averages

While quarterly market share movements show occasional signs of deterioration....

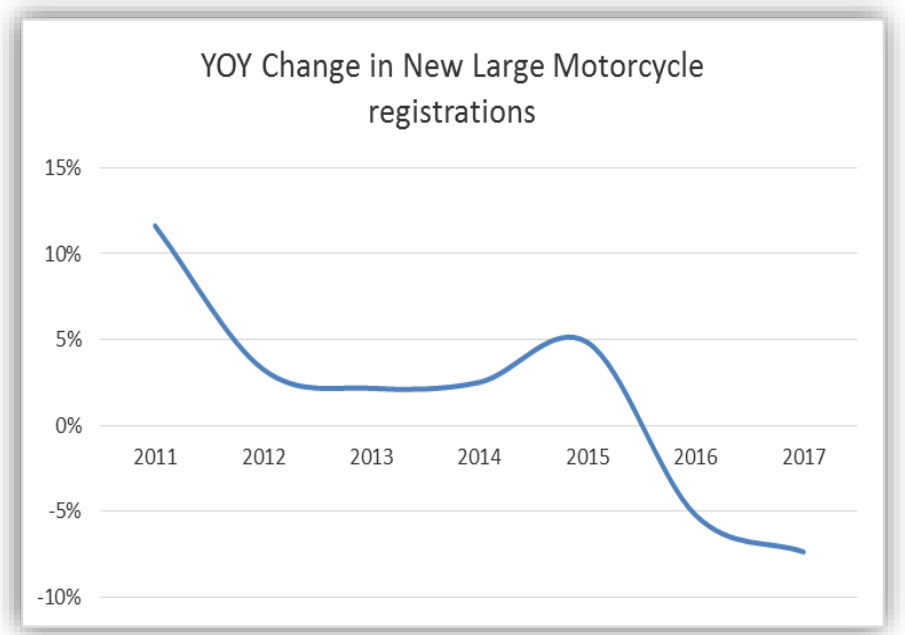
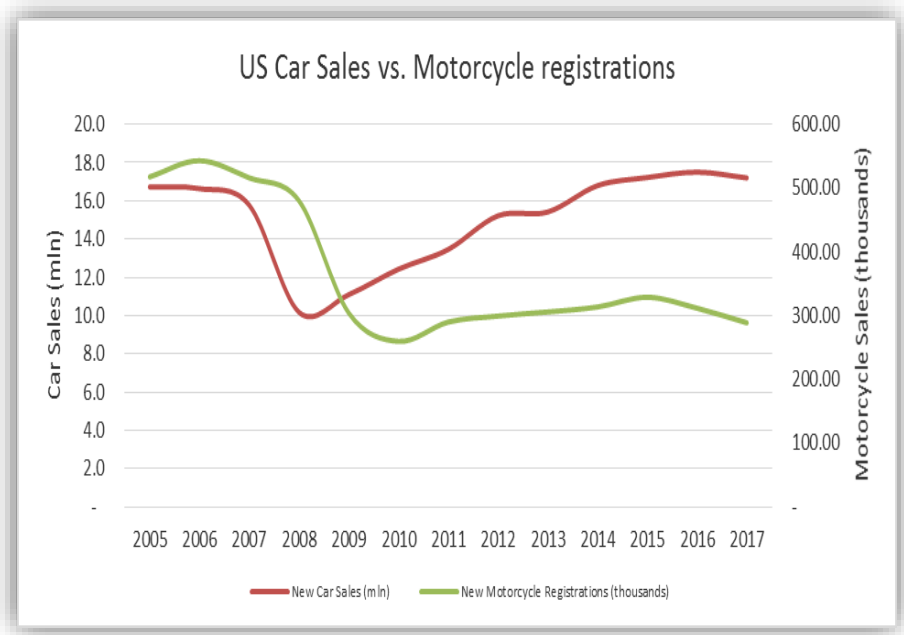


...20-year view shows how stable brand really is



# Motorcycle Market

- U.S. Motorcycle Sales are still 45% below 2006 peak
- Sales declined in last two years after short period of recovery
- Fears of generational shift away from motorcycles dominate the headlines



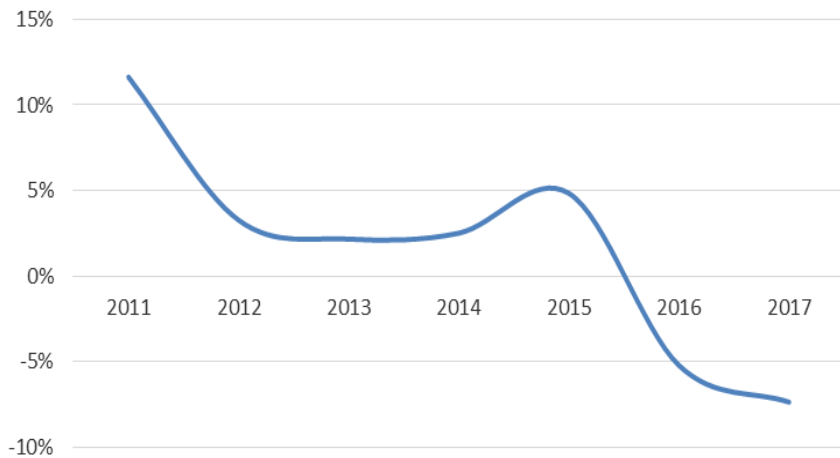
Source: Company Data, Bloomberg



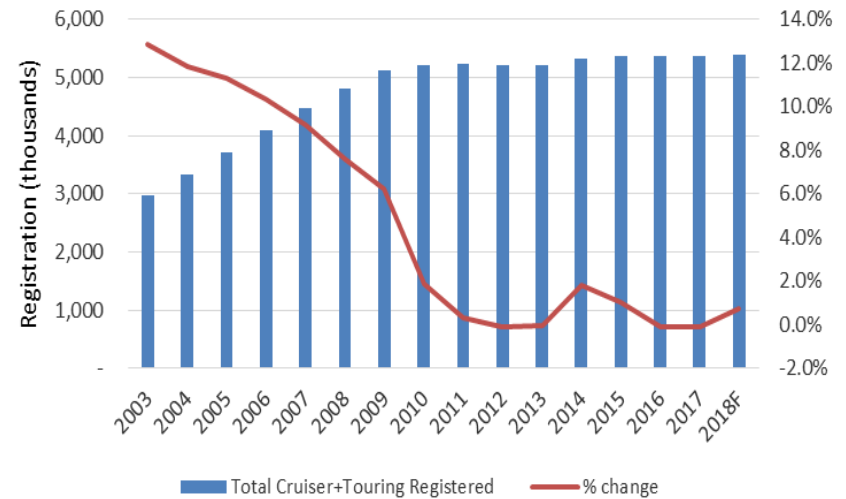
# Motorcycle Market (cont'd)

- While new sales of large bikes have fallen, total registrations are at all time highs
- Cruiser & Touring registrations as % of all on-road motorcycles on road have stayed steady at over 60%
- 5.4 million total bike registrations

YOY Change in New Large Motorcycle registrations

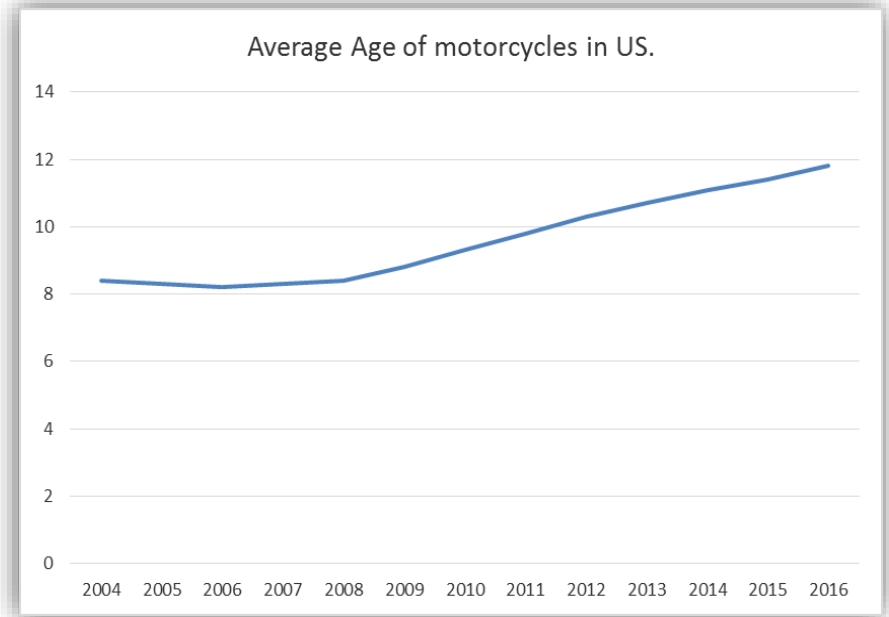
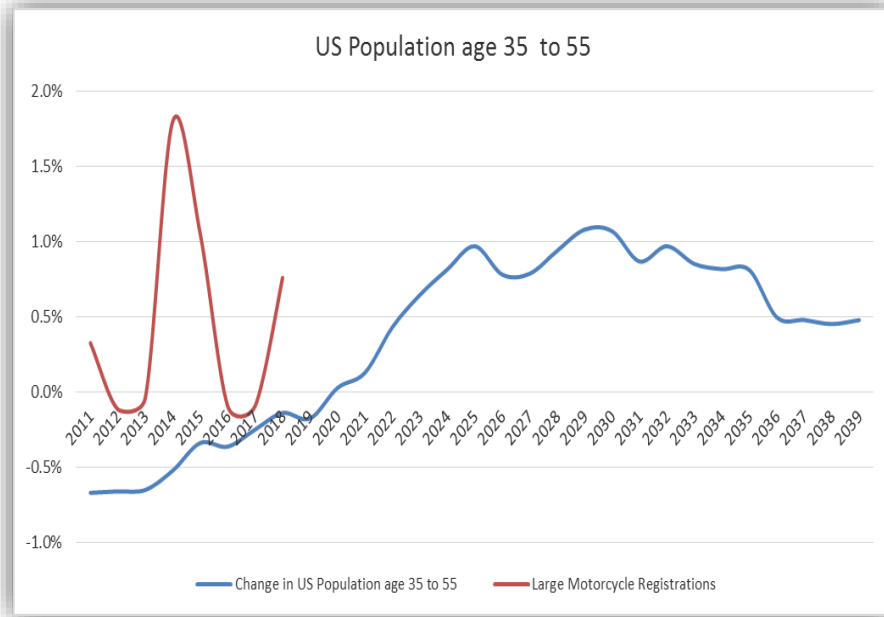


All Cruiser and Touring Registrations



# Motorcycle Market poised for recovery

- Average age of motorcycle on the road has increased from 8 to 12 years since 2004
- The 35 to 55 cohort of U.S. population will start growing in 2019 due to aging of baby boomers
- Number of Harley Riders increased by 32,000 in 2017
  - Training new riders through H-D Riding Academy



# HOG – Two Great Business (not one)

Harley Davidson (NYSE: HOG)  
\$8B MCAP; \$14.5B Enterprise  
Value

## Harley Davidson Financial Services (HDFS)

- Primary financing provider in HD dealerships
- Average ROE of 18% over last 6 years; going up to 23%
- \$6.3B of debt
- BV of \$1B
- 2017 operating income of \$275 million

## Harley Davidson Motorcycle Corporation (HDMC)

- Sells 1 out of 2 large motorcycles in US
- ROIC close to 100%
- 2017 operating income of \$615 million
- Debt/EBITDA of less than 1x



# Harley Davidson Financial Corporation

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- **Exists to generate profit, not subsidize motorcycle business**
- **Primary financing option for new Harley Davidson purchases**
  - Finances 1 out of 2 bikes sold in the dealership; only option for subprime buyers
  - Provides wholesale funding to dealerships
- **HDFS as a bank**
  - Lends at ~6%, borrows at 2.9%
    - Accelerated interest amortization schedule results in ~6% NIM
  - Cost of Risk ~1.9%; 90 day past due provision coverage – 4.8x
  - Cost Income of 20%
- **High ROE, despite relatively low leverage**
  - Average historical ROE of 19%; Going up to 23% due to lower taxation
  - Equity over assets = 16%, compared to less than 10% for a typical bank



# Harley Davidson Motorcycle Corporation

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## ➤ **Consistently high operating profitability**

- Customers are not price sensitive; revenues per motorcycle grow about 2% per year – partially driven by product mix
- Brand image creates differentiation
- Operating Margin of 12%
- ROIC of 80%

## ➤ **EBITDA of ~ \$0.8 to \$1 billion**

- Requires no capital expenditures beyond maintenance CapX of ~\$250 million per year
- Free cash flows are paid out via dividends and buybacks yielding 9% to current market value

## ➤ **Market sees much higher multiple due to the consolidation of financial services debt**

- Total debt \$7 billion
- Non-financial debt \$700 million – close to cash balance



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# Harley Davidson Value

- HDFS is worth approximately \$2.5B as a standalone business
  - Market values specialty finance companies at about 1x BV for each 7.5% of sustainable ROE

HDFC Historical ROE	19%
Assumed P/B	2.6x
Book Value	\$ 983.52
<b>Estimated Value</b>	<b>\$ 2,511.27</b>

- Motorcycle business is effectively trading at 7.7x EV/EBITDA

Total Debt	\$ 6,988.37
Financial Debt	\$ 6,246.41
Net Debt	\$ 741.96
Cash	\$ 338.00
Net Debt	\$ 403.96
Market Cap	\$ 7,913.12
<b>Market Cap (ex- financials)</b>	<b>\$ 5,401.84</b>
<b>EV</b>	<b>\$ 5,805.81</b>
<b>2018E Ebitda (ex-financials)</b>	<b>\$ 751.58</b>
<b>2018 EV/EBITDA (ex - financials)</b>	<b>7.7x</b>
<i>ROIC</i>	<i>102%</i>

Market Value as of 6/7/2018; Financials as of 12/31/2017



# FCF Generation and Use

- Harley Davidson generated over \$8 billion in operating cash flow since 2010
  - Spent \$1.8B on Maintenance CapX and one small acquisition
  - Remainder was paid out to shareholders

	2010	2011	2012	2013	2014	2015	2016	2017
EBITDA	\$ 979.3	\$ 1,078.4	\$ 1,197.6	\$ 1,320.8	\$ 1,460.3	\$ 1,353.8	\$ 1,258.5	\$ 942.1
Operating Cash Flow	\$ 1,163.4	\$ 885.3	\$ 801.5	\$ 977.1	\$ 1,146.7	\$ 1,100.1	\$ 1,174.3	\$ 1,005.1
CapX	\$ (170.8)	\$ (189.0)	\$ (189.0)	\$ (208.3)	\$ (232.3)	\$ (260.0)	\$ (256.3)	\$ (206.3)
M&A						\$ (59.9)		
<b>FCF after CapX</b>	<b>\$ 992.6</b>	<b>\$ 696.3</b>	<b>\$ 612.5</b>	<b>\$ 768.8</b>	<b>\$ 914.4</b>	<b>\$ 780.2</b>	<b>\$ 918.1</b>	<b>\$ 798.8</b>
<b>% of current MCAP</b>	<b>13%</b>	<b>9%</b>	<b>8%</b>	<b>10%</b>	<b>12%</b>	<b>10%</b>	<b>12%</b>	<b>10%</b>
Dividends	\$ (94.1)	\$ (111.0)	\$ (141.7)	\$ (187.7)	\$ (238.3)	\$ (249.3)	\$ (252.3)	\$ (251.9)
Buybacks	\$ (1.7)	\$ (224.5)	\$ (311.6)	\$ (479.2)	\$ (615.6)	\$ (1,537.0)	\$ (465.3)	\$ (465.4)
<b>Total Cash Returned</b>	<b>\$ (95.9)</b>	<b>\$ (335.6)</b>	<b>\$ (453.3)</b>	<b>\$ (666.9)</b>	<b>\$ (853.9)</b>	<b>\$ (1,786.3)</b>	<b>\$ (717.7)</b>	<b>\$ (717.3)</b>
<b>% of current MCAP</b>	<b>1%</b>	<b>4%</b>	<b>6%</b>	<b>8%</b>	<b>11%</b>	<b>23%</b>	<b>9%</b>	<b>9%</b>

- Annual FCF yield is over 10% compared to < 3% for 10 yr treasuries
  - 3.5% dividend yield
  - Shares outstanding down by 29% since 2011



# Valuation and IRR

- Each position in Firebird U.S. Value Fund is considered based on the long-term IRR that includes dividends and share buybacks
- Harley Davidson 5 year IRR is estimated at ~14% once intermediate cash flows are taken into account\*

## IRR

Date	6/7/2018	5/31/2018	5/31/2019	5/31/2020	12/31/2020
Purchase Price	(7,913)				
Dividend		223	218	209	
Buyback		326	354	405	
Exit MCAP @ avg. comps multiple					9,049
Total CFs	(7,913)	549	572	614	9,049
<b>IRR</b>	<b>14.5%</b>				

- Current Fair Market Value of HOG is \$55-\$60 per share (30% to 40% upside)

	2018	2019	2020	2021
FCF	683	393	580	558
PV of CF	647	338	454	397
EV/EBITDA	6.x	7.x	8.x	9.x
FV	6,998	8,220	9,442	10,664
PV	4,981	5,851	6,720	7,590
<b>Total Enterprise Value</b>	<b>6,818</b>	<b>7,688</b>	<b>8,557</b>	<b>9,427</b>
<b>Value of Financial Business (@2.6x bv)</b>	<b>2,557</b>	<b>2,557</b>	<b>2,557</b>	<b>2,557</b>
<b>MCAP</b>	<b>9,375</b>	<b>10,245</b>	<b>11,115</b>	<b>11,984</b>
<b>Price per Share</b>	<b>\$50.94</b>	<b>\$55.67</b>	<b>\$60.40</b>	<b>\$65.12</b>
<b>Upside from Current</b>	<b>18%</b>	<b>29%</b>	<b>40%</b>	<b>51%</b>



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# Summary & Contact

- Name synonymous with motorcycles
- Conservative financial business with 19% average ROE – 23% going forward
- Large motorcycle market is poised for recovery
- 8% of current market cap returned via dividends and buybacks
- Leverage of financial business hides how cheap company really is
- Estimated 30% upside from current price
- Estimated 14% IRR for the long term investor



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# Appendix: HDFS Selected Historical Financials

	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Interest Income	\$ 278.70	\$ 294.38	\$ 303.52	\$ 420.48	\$ 635.21	\$ 598.68	\$ 583.70	\$ 575.65	\$ 585.19	\$ 605.77	\$ 628.43	\$ 633.11	\$ 639.76	\$ 649.36	\$ 668.84
% of receivables	9.9%	9.8%	7.7%	8.5%	11.1%	9.9%	9.9%	9.6%	9.2%	8.9%	9.0%	8.9%	8.9%	8.9%	8.9%
Other Income	\$ 106.20	\$ 121.82	\$ 73.45	\$ 74.30	\$ 47.50	\$ 50.77	\$ 54.22	\$ 65.93	\$ 75.64	\$ 80.89	\$ 96.65	\$ 99.08	\$ 95.96	\$ 97.40	\$ 100.33
as % of interest	38%	41%	24%	18%	7%	8%	9%	11%	13%	13%	15%	16%	15.0%	15.0%	15.0%
Financial Services Revenue	\$ 384.90	\$ 416.20	\$ 376.97	\$ 494.78	\$ 682.71	\$ 649.45	\$ 637.92	\$ 641.58	\$ 660.83	\$ 686.66	\$ 725.08	\$ 732.20	\$ 735.73	\$ 746.76	\$ 769.16
Interest Expense	\$ 59.80	\$ 81.48	\$ 136.76	\$ 283.63	\$ 272.48	\$ 229.49	\$ 195.99	\$ 165.49	\$ 164.48	\$ 161.98	\$ 173.76	\$ 180.19	\$ 182.83	\$ 185.57	\$ 191.14
% of debt			3.7%	6.6%	5.3%	4.2%	3.8%	3.4%	3.1%	2.8%	2.8%	2.9%	2.9%	2.9%	2.9%
NIM			4.0%	1.9%	5.8%	5.7%	6.1%	6.2%	6.1%	6.1%	6.1%	6.0%	6.0%	6.0%	6.0%
Provisions for credit losses	\$ 5.90	\$ 11.25	\$ 39.56	\$ 169.21	\$ 93.12	\$ 17.03	\$ 22.24	\$ 60.01	\$ 80.95	\$ 101.35	\$ 136.62	\$ 132.44	\$ 114.52	\$ 108.97	\$ 112.24
as % of average receivables		0.4%	1.0%	3.4%	1.6%	0.3%	0.4%	1.0%	1.3%	1.5%	1.9%	1.9%	1.6%	1.5%	1.5%
Operating Expenses	\$ 108.50	\$ 111.30	\$ 117.89	\$ 128.22	\$ 135.23	\$ 143.81	\$ 135.01	\$ 132.99	\$ 137.57	\$ 143.13	\$ 139.18	\$ 144.26	\$ 144.95	\$ 147.12	\$ 151.54
Cost/Income	28%	27%	31%	26%	20%	22%	21%	21%	21%	21%	19%	20%	20%	20%	20%
Operating Income	\$ 210.70	\$ 212.17	\$ 82.77	\$ (86.28)	\$ 181.87	\$ 259.11	\$ 284.69	\$ 283.09	\$ 277.84	\$ 280.21	\$ 275.53	\$ 275.31	\$ 293.42	\$ 305.09	\$ 314.24
Fully Taxed	\$ 136.96	\$ 137.91	\$ 53.80	\$ (56.08)	\$ 118.22	\$ 168.42	\$ 185.05	\$ 184.01	\$ 180.59	\$ 182.13	\$ 179.09	\$ 178.95	\$ 231.81	\$ 241.02	\$ 248.25
ROE			5.9%	-6.3%	13.2%	17.5%	19.2%	19.7%	19.0%	18.0%	17.3%	17.8%	23.3%	23.7%	23.8%
VIE															
Finance Receivables					3,383.4	2,863.6	2,101.6	1,537.3	1,426.4	1,573.7					
% of total		0.0%	0.0%	0.0%	56.2%	49.5%	36.3%	25.6%	22.2%	22.9%					
Debt					2,755.2	2,087.3	1,447.8	1,256.6	1,271.5	1,463.2					
% of total		0.0%	0.0%	0.0%	47.9%	36.5%	28.4%	23.9%	23.1%	21.2%					
Net Receivables	\$ 2,827.3	\$ 3,201.6	\$ 4,679.6	\$ 5,207.2	\$ 6,191.2	\$ 5,912.1	\$ 5,889.5	\$ 6,110.3	\$ 6,560.2	\$ 7,015.3	\$ 7,008.8	\$ 7,157.6	\$ 7,157.6	\$ 7,372.3	\$ 7,593.5
Growth		13.2%	46.2%	11.3%	18.9%	-4.5%	-0.4%	3.7%	7.4%	6.9%	-0.1%	2.1%	0%	3%	3%
Provisions	\$ 27.3	\$ 30.3	\$ 40.1	\$ 150.1	\$ 173.6	\$ 125.4	\$ 107.7	\$ 110.7	\$ 127.4	\$ 147.2	\$ 173.3	\$ 192.5			
% of receivables	1.0%	0.9%	0.8%	2.8%	2.7%	2.1%	1.8%	1.8%	1.9%	2.1%	2.4%	2.6%			
Receivables more than 90 days past due	\$ 6.5	\$ 8.4	\$ 25.0	\$ 26.8	\$ 35.7	\$ 28.4	\$ 28.0	\$ 24.8	\$ 28.9	\$ 32.8	\$ 40.7	40.076			
% of receivables	0.2%	0.3%	0.5%	0.5%	0.6%	0.5%	0.5%	0.4%	0.4%	0.5%	0.6%	0.6%			
90 day coverage	4.20	3.63	1.61	5.60	4.86	4.42	3.84	4.46	4.40	4.49	4.26	4.80			
Liabilities															
Debt			\$3,733.29	\$4,831.17	\$5,449.36	\$5,419.62	\$4,799.65	\$4,956.17	\$5,504.63	\$6,143.45	\$6,066.26	\$6,246.41	\$6,246.41	\$6,433.80	\$6,626.81
Equity			\$ 912.33	\$ 856.37	\$ 940.21	\$ 986.54	\$ 941.08	\$ 929.22	\$ 975.85	\$1,042.62	\$1,031.88	\$ 983.52	\$1,006.70	\$1,030.80	\$1,055.63

Source: Company Data, Firebird U.S. Value Fund projections

