Harley, you're not getting any younger

As its baby-boomer core clientele grays and the economic crisis bites, the road ahead looks bumpy for the motorcycle maker

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Spuck Bennett's dealership just outside Ocean City, Maryland, is cluttered with 65 shiny Harley-Davidson motorcycles, including the chrome Sportster and the sleek V-Rod. Last year, Bennett, 79, sold 200 bikes, down from 280 the year before. This year, sales have slowed to a crawl.

"I haven't seen anything like this in the 33 years I've owned a dealership," he says. "We're just trying to survive." He has cut expenses by trimming hours and overtime, and laid off seven of his 49 employees.

After riding high for two decades, the company that makes the hulky bikes that devoted riders affectionately call Hogs is sputtering. Harley's core customers are graying baby boomers, whose savings, in many cases, have gone up in smoke in the market downturn. Few are in the mood to shell out up to US$20,000 or more for something that is basically a big toy, and the company, in turn, has not captured much of the younger market.

And though Harley's woes pale in comparison to what the automakers face — Harley's revenue dipped 2 percent last year while Detroit was crashing — overproduction and loose lending practices have burdened the company's finances.

In a pattern similar to that of the housing bust, Harley goosed sales by luring many buyers with no-money-down loans. A subsidiary created about 15 years ago, Harley-Davidson Financial Services, made those loans and packaged them into securities to sell to investors. As the credit market skidded, so did this subsidiary.

As much as one-fourth of the US$2.8 billion in loans issued by Harley-Davidson Financial Services last year were subprime, with interest rates as high as 18 percent. As the downturn took hold, some borrowers started defaulting on loans and investors stopped buying the securities, forcing Harley to write down US$80 million of debt last year, analysts said. Although it recently tightened lending standards, the company is still chasing buyers by offering credit.

"It's an unsustainable strategy to continue financing this way," says Robin Farley, an analyst with UBS. "In the last few months, they've been running into a liquidity wall."

Tom Bergmann, Harley-Davidson's chief financial officer, defends the company's lending practices. "It's not easy in this environment," he said. "We have to give loans to customers, but only to those worthy, and we've been disciplined and prudent in granting credit to our customers."

In large part because of loan problems, though, profits at Harley fell 30 percent last year, to US$654.7 million on revenue of US$5.6 billion. Operating income of the financial subsidiary fell 61 percent, to US$83 million.

UNEASY RIDERS

Concerns about Harley's future grew after the departures of its two top executives were announced. In December, Jim Ziemer, 59, said he planned to retire as chief executive this year. In early January, the company announced that Saiyid Naqvi, the head of the finance unit, was resigning after less than two years at Harley. Since September, Harley's stock has plunged 70 percent, to less than US$13, compared with a 36 percent decline for the Standard & Poor's 500.

Like many cash-tight companies, Harley, based in Milwaukee, is finding that borrowing is difficult — and expensive. Early last month, Harley announced that Berkshire Hathaway, Warren Buffett's company, would buy US$300 million of its unsecured debt. (Harley reported total debt of US$3.9 billion last year, more than double what it held in 2007.) In exchange for his good name and millions, Buffett demanded 15 percent interest from Harley on his investment (similar to deals he received from Goldman Sachs and General Electric when he invested in those companies last fall).

Harley's largest investor, Davis Selected Advisers, matched Buffett's deal, pumping US$300 million more into the company, also at 15 percent interest.

But even US$600 million isn't enough to enable the financial arm to continue making loans through year-end. Company executives announced that the finance unit needed a total of US$1 billion for loans. While that's one-third lower than last year, the executives are bracing for plummeting sales and continued frozen securities markets.

Congress included the motorcycle industry in a Treasury Department program intended to unclog financial markets by lending to investors buying securities backed by mortgages and other types of loans. It was uncertain, however, how much Harley would receive — and when — making this an unreliable source of capital. And while Bergmann said he had met with several banks since doing the Berkshire and Davis deals, he had not yet announced any new loans.

Harley's road has perhaps never looked so hazardous.

If the company can't obtain new sources of money to offer loans to customers, they will have to try to borrow elsewhere. But in this credit crisis, qualifying for a loan isn't easy. A lack of credit would probably depress bike sales even further, which in turn would make it harder for Harley to repay Berkshire and Davis.

"If the securities market continues like it is, then Harley faces very serious issues," said James Hardiman, senior research analyst at FTN Midwest, a brokerage firm in Cleveland. "Harley has been able to find different sources of funds, but the securities market is the only way they can unload the debt from their books."

Ziemer, Harley's chief, says: "We have a strong business that's anchored by an iconic brand. But as we look at 2009, it'll be a challenging year for the business."

Harley has lived through troubled times before. The company is 106 years old, after surviving the Great Depression and a major blow in the 1970s when sales grew sharply for cheaper bikes from Japanese makers like Honda and Kawasaki. The company even flirted with bankruptcy in 1985 as its foreign rivals soared.

But Harley persevered by capitalizing on its revered brand, made famous in movies like *Easy Rider*, and more recently by appealing to boomers' desire to recapture their youth.

When customers buy a Harley, they're instantly a member of a family of zealous fans — guys with tattoos and unruly hair as well as lawyers and doctors. (The average household income of today's rider is about US$87,000.)

The company's Harley Owners Group program, founded in 1983, has more than 1 million members who come together for rallies and rides, swapping their favorite touring stories and chatting about new product lines.

"Harley brings together all walks of life," says Mark-Hans Richer, Harley's chief marketing officer. "You'll find a neurosurgeon talking and riding with a janitor. It's a family."

By building such a powerful brand with offbeat, behind-the-scenes efforts — little advertising, lots of accessories and minor visible changes to bikes over the decades — Harley has become a case study for academics, marketing gurus and other corporations. But Harley's longtime strategy of marketing to the boomers, which was a blazing success, is now backfiring.

Its core customers have grayed, and they are buying new bikes less often. The average age of a Harley rider is 49, up from 42 five years ago. But company executives don't seem outwardly worried by the lackluster growth among those 35 and younger, even as it takes steps to turn them into Harley owners.

NOT THE END OF THE ROAD

They say they're confident that the baby-boom generation has 15 more years of riding life. "They're not about to stop riding because they're getting older," Richer says. "It would be dumb to walk away from our core customer, the most lucrative customer."

In an effort to make inroads with bikers in their 20s and 30s, Harley poured money into developing the V-Rod, a high-powered cruiser that starts at about US$15,000. The company says the V-Rod is successful, but even so, the sport market represents only 12 percent of Harley's sales, analysts say.

"Harley understands the baby-boomer consumer incredibly well, in a holistic sense," says Gregory Carpenter, a marketing professor at the Kellogg School of Management at Northwestern. "But to grow and thrive, they must create a deep emotional connection with younger consumers."

A decade ago, Harley executives made a decision that, along with the loan push, now appears to be a major contributor to its current problems. Determined to appease consumers who were stuck on two-year waiting lists, the company ramped up production. Last year, Harley built more than 303,000 bikes, up from 159,000 in 2000.

Some dealers also took advantage of heightened demand for Harleys to charge more, a move that may have done long-lasting harm. "Dealers were charging more than the suggested manufacturer price and it made Harley look greedy and jeopardized our brand that we spent a long time building," Ziemer said.

Now, with so many Hogs in the marketplace, Harley has an issue involving its brand.

"Traditionally, Harley-Davidson had a very loyal consumer," says Anthony Gikas, senior research analyst at Piper Jaffray. "But those riders lost interest in the brand because everyone has a Harley bike. It's not a club anymore."

To offset weakening sales, Harley is paring production this year, to about 270,000 bikes and is shuttering two plants. In addition, the company will cut 1,100 of 9,000 jobs over the next two years.

To curb additional loan defaults, Harley adopted stricter credit standards in November, requiring buyers to put down 20 percent.

Motorcycle consultants and analysts argue that Harley should take more drastic steps, including beefing up efforts to court younger riders.

Making major changes isn't easy, especially for a brand with an image so deeply ingrained in pop culture. Harley executives say they are committed to regaining their momentum.

"We're encouraging our designers to think out of the box," Ziemer said. "We have to be quicker, more responsive to what our customers want. And we will."

Clockwise from left: The Harley-Davidson staff in 1907; Spuck Bennett pictured at his Harley-Davidson dealership in Seaford, Delaware, where sales have plummeted. "Were just trying to survive," he says; The Harley-Davidson brand was propelled by movies like *Easy Rider*; The Harley-Davidson V-Rod, a cruiser that costs about US$17,000.

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