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Tesla: A Capital Markets Tale-The Final Chapter

Lead Up to Final Chapter: The Big Dream

Tesla is a classic example of why the capital markets exist. Elon Musk is to be congratulated for taking the idea of the Electric Vehicle (EV) from concept to reality and pulling forward the other auto makers into the EV space way earlier than they would have otherwise. He started in the high-end market, designed the Model S Luxury Sedan and bought his Fremont California manufacturing plant from Toyota for $42 million with capacity for 500k units in the depths of the financial crisis. He also received a $465 million loan from the department of energy to get things going as well.

Many of his detractors then said that without his loans from the Obama administration and the EV subsidy he wouldn't be able to stand on his own. While that statement was true it really didn't matter. If the US government under the Obama Administration wanted to make EV's a reality and the Fed was making the cost of money free, why would you as a short seller fight this endeavor with Elon as the anointed one with a virtually free auto plant? Well the answer was that many folks did, and the stock was a battle ground from its IPO in 2010 until Q1 of 2013. While I was an equity growth PM at BlackRock, we accumulated a 2% position in TSLA during 2011 and 2012 in the $25-$35 range.

My thesis was very simple at the time as I thought Tesla was a call option on the EV market. If Elon was right and could bring a car to consumers, we saw 300-400% upside and if he was wrong we would lose 50-60% of our 2% investment immediately. My upside target was predicated on my knowledge of the history of the capital markets. If you create a company with a disruptive technology that can lay claim to a large market share land grab and you demonstrate an ability to execute then the valuation of your company will balloon and frankly valuation doesn't matter. The risk between 2011 and 2012 was that Elon would stumble and the Model S would never get out of the gate. Eventually he did deliver a very popular Model S in 2013 and many investors suddenly 'discovered' Tesla at much higher prices and began to drink the Kool-Aid and give Elon copious amounts of capital to help build his "Champagne Wishes and Caviar Dreams" company. In hindsight I did not realize how absurd the valuation would become as many growth investors dreamed very big dreams.

The Dream Ends & The Nightmare Begins

As an active former bull on Tesla one might find it curious that I would flip to a bear and initiate a short position on this stock. If my original thesis was that Tesla was a call option on the EV market and that Elon would create the space driving his valuation up, then to keep me in the stock I would have to switch from dreams to reality to see if the valuation can be supported as competition nears. Unfortunately for Elon and those that have provided capital, the dream has morphed into a Freddy Krueger style nightmare. Below is the bullet point list of negatives that I see on the horizon and I will briefly address each one. There is a very good chance that a massive

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equity dilution or bankruptcy could occur over the next 6-12 months for this stock as a host of perfect storm events are occurring simultaneously.

- Competition in both the high-end EV market and the EV mass-market is arriving this year from well healed competitors and Elon has not even secured any market share in the mass market (Model 3)
- Model 3 is plagued with production and quality control problems
- Key executive departures are beyond alarmingly high especially in the finance department
- Cash flow is negative, and the company needs to raise a substantial amount of capital with whispers of SEC violations and fast and loose accounting standards
- Elon Musk has made a multitude of dubious forward-looking statements that may have mislead investors and has demonstrated some increasingly bizarre behavior of late
- Recent debt downgrade of the 2025 notes to Caa1 from B3 by Moody's and debt spread widening versus treasuries
- Fed tightening, business cycle risk and the end of free money

Source: Bloomberg

Competitor Capital Arrives with Product and Elon is Late to Market on Model 3

Usually these obscene valuations attract the envy and ire of others and eventually capital is deployed into that space bringing with it competition, excess capacity and ultimately lower returns. In the auto industry it takes roughly 5 years to bring a car from design to mass production of a quality-controlled product. Unfortunately for Tesla shareholders, that competition is here in 2018 and its either priced cheaper, has better technology or both. Elon has had 5 years to

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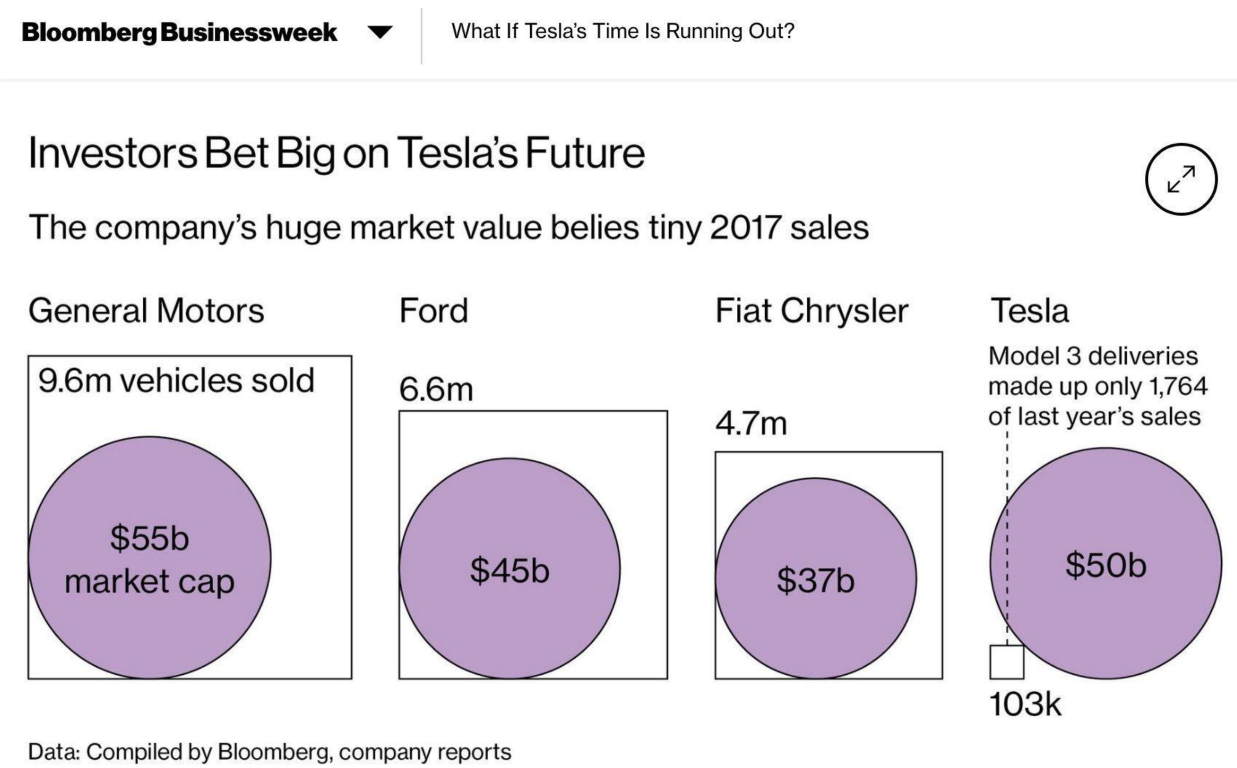
cement his lead and grab as much market share as he could before the onslaught of competition arrived. How has Elon done with the 5 years? He is currently delivering 103,000 units as of 2017 most of which is the high-end market and commands a $48 billion valuation versus similar valuations of Ford and GM (see graphic below).



His current obscene valuation is predicated on him ramping up the Model 3 and delivering a cost-effective vehicle to the mass market. So far Elon has had to halt production twice on the Model 3 and walk back his claims of having a fully automated plant that would reinvent how the auto industry makes cars. It looks like costs are increasing meaningfully at a time when cash flow is desperately needed (Tesla to Halt Production). In addition there are reports of quality problems on the Model 3 which won't help its brand as the competition begins to deliver quality products at reasonable prices (Quality Issues). The bottom line is that Elon's time is up and his valuation of $48 billion could have been supported if he had delivered a Model 3 mass market EV 2 years ago and secured some market share but given that he didn't the current expectations built into his stock are simply unrealistic at this point (Model 3 Competition Arrives).

Executive Departures are Beyond Alarming

In my 26 years of experience as an analyst and a PM, when executives leave unvested restricted stock and options on the table it's a signal that they don't think the prospects are very good for their own company. I live by the edict "watch what people do rather than what they say." The list of departures at Tesla is quite staggering and speaks volumes about what they see coming for

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Tesla and it must be grim indeed. One of the great short sellers of our time, Jim Chanos, described Tesla's executive departures on CNBC recently as "stunning" (Chanos On Tesla Executive Departures). Most troubling are the recent finance department departures in March which doesn't make investors feel very warm and fuzzy about the numbers (Finance Executive Departures). And finally the most recent departure was Tesla's Autopilot Chief Jim Keller who left April 26th to go to Intel (Tesla Loses Autopilot Chief). Clearly, they see what is coming and it is likely a disaster of epic proportions.

Cash Flow is Negative at a Time Capital Is Needed

The cash flow picture at Tesla is not good as they try to ramp the Model 3 to 5,000 units a week. Below is a graph of the cash flow trend of Tesla over the Years. They are burning about $2 billion a year in FCF and for the Model 3 ramp they likely need to raise $3-5 billion.

Source: Bloomberg

In addition, there are speculations that there are ongoing undisclosed SEC probes that may prohibit Tesla from accessing the capital markets now. And finally, the cash flow situation may be worse than previously known due to loose accounting standards at Tesla. Gordon Johnson of Vertical Group has spotted a potential $3.4 billion hole in Tesla's balance sheet:

*"Unlike anything we've ever seen in GAAP accounting**, when TSLA orders equip., or invests to construct a building, a portion of the associated CAPEX is deferred,** a large chunk of which seems to coincide w/ the start of Model 3 production. TSLA accounts for this as an "Accrued Purchases", overstating/understating free-cashflow/ expenses." (Analyst Spots $3.4 Billion Hole in Tesla's Balance Sheet)*

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Elon's Statements & Behavior are Increasingly Erratic

Elon seems to disagree with the myriad of Wall Street Analysts who believe that a substantial capital raise is needed as illustrated by this tweet on April 12th

This tweet was likely a forward-looking statement during the earnings blackout period that Elon will come to regret someday. Also, it is virtually impossible for him to achieve profitability and be cash flow positive in Q3 & Q4 and this statement is likely very misleading as well.

Increasingly Elon's behavior seems out of place for someone that is launching a mass market car that will make or break his company. For example, he was in Israel posting social media pictures of himself with flaming absinthe (Flaming Absinthe) on March 20th then 26 days later he is sleeping on the factory floor in Fremont as the Model 3 production is halted but decides it might be a good idea to tweet the following:

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Elon Musk @elonmusk · Apr 14
Too wasted to remember

36 205 1.9K

Elon Musk
@elonmusk

Following

Replying to @elonmusk @La3_id @TheOnion

Additionally, on April 1st a few days after the Moody's downgrade he thought it would be a funny April fools joke to tweet the following:

Elon Musk @elonmusk · Apr 1

Elon was found passed out against a Tesla Model 3, surrounded by "Teslaquilla" bottles, the tracks of dried tears still visible on his cheeks.

This is not a forward-looking statement, because, obviously, what's the point?

Happy New Month!

3.7K 22K 121K

It has been well known for the last couple years that Elon has not been entirely focused on Tesla's business given his interest in SpaceX, Solar City and a myriad of other companies he continues to talk about incessantly. However, his recent tweets demonstrate a lack of seriousness and understanding of the gravity of the situation this company finds itself in now. The fact that his debt was downgraded to junk appears to be lost on Elon as well. Also, I think it's fair to ask the

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question: Might Elon's erratic behavior also have something to do with all the recent executive departures?

Moody's Downgrade and Debt Spread Widening are Ominous

Before we initiated the short in Tesla's shares I had my Fixed Income Partner, Rich Mowrer, take a look at the balance sheet. 24 hours later he came back to me and said:

"Tesla is effectively insolvent, but it depends on whether the capital markets will continue to fund this company."

Upon hearing that sentence I urged an immediate short sale position on March 8th since I was confident they needed cash badly and that the debt markets would force a very unfavorable capital raise if one could be done at all. Moody's downgraded Tesla's debt on March 27th and the spreads widened considerably. (Moody's Downgrades Tesla Outlook Negative)

Source: Bloomberg

My other Fixed Income Partner, Chris Coolidge, said to me after the downgrade:

"Tesla is bleeding cash at an unsustainable rate. No chance they can earn their way out of this downward spiral. Rating agencies seem afraid to appropriately downgrade this burning trash heap where ratings reflect reality. I've seen lower rated junk bonds with better balance sheets than Tesla."

Bottomline is that when you are a growth company and your growth is in the hands of the bond vigilantes, they are not as easily duped by clever story telling or the cult of personality.

Fed Tightening, Business Cycle Risk and the End of Free Money

In addition to Tesla's myriad of problems the stock is also under pressure from what we believe is a regime change in risk appetite. We believe that US bond yields have topped, the dollar has bottomed and that we are seeing a synchronized global slowdown due to Fed tightening. In this

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environment it will be very difficult for Tesla to raise capital at attractive terms and will likely contribute to the negative financial reflexivity that has begun with Tesla's debt and equity the last two months.

Conclusion

Due to the unique collaboration of both equity and fixed income PMs we were able to see that a Tesla short was very timely due to its worsening liquidity position and our belief that risk assets are coming under pressure due to a global slowdown. The Tesla saga is a classic American tale of capitalism and the capital markets at work. An entrepreneur attracts capital and trail blazes a whole industry. He can either dominate it or be marginalized by the competing capital attracted to his space that inevitably reduces returns. In Elon's case he squandered a first mover advantage by becoming distracted with other businesses and his hubris that being first was also being smart. Our guess is that this stock will be much lower over the next 12 months with the very real possibility of bankruptcy.

Source: Bloomberg

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Source: Bloomberg

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