

Collapsing Demand amid a new Criminal Probe at Tesla | Gordon Johnson

September 20, 2018

INTRODUCTION

So I want to talk about Q3 and the magic that we believe Tesla is going to pull to show good numbers, both revenue, profit, and cashflow, but I think that ... if they're doing what we think they're doing ... we believe they may have crossed over into committing outright accounting fraud. – Gordon Johnson

What's up everybody? Welcome to this week's episode of Hidden Forces with me, Demetri Kofinas. Today, I speak with Gordon Johnson. Gordon has more than 8 years of experience as an equity research analyst and was recently ranked by Bloomberg among the top stock pickers in the solar space since initiating coverage in 2008. Prior to focusing on the solar sector, Mr. Johnson covered semiconductor technology and solar companies at Lehman Brothers. He received a BA with a major in both Finance and Economics from Morehouse College in Atlanta, GA. Mr. Johnson has been recognized for his accurate stock picks in numerous publications including Bloomberg, Barron's, Forbes, The Wall Street Journal, Reuters, The Financial Times, and TheStreet.com. Gordon has also had numerous appearances on Bloomberg T.V. and CNBC.

OVERVIEW

When we last covered Tesla in April of 2018, we knew that the company ended 2017 with \$3.4 billion in cash and equivalents while having raised an additional \$550 million from bonds backed by lease payments in February 2018. They were also losing \$28,000 on each car sold with long-term debt and battery purchase obligations at \$31.4 billion and run-rate interest expense of nearly \$600 million per year with a debt-to-equity ratio as 243% as of December 30th, 2017.

In Q2 Tesla lost \$17,600 per car delivered, but that will improve in Q3 due to much higher volumes of Model 3 and sale of ZEV credits they stored and didn't use in Q2. The run-rate interest expense is \$654 million/year and the cash was \$2.236 billion but \$942 million of that was customer deposits and the accounts payable were really stretched so the cash is deceptively high.

Market Summary
NASDAQ: TSLA



August-September Timeline

On August 1st, Tesla reports the **largest quarterly loss in its history** showing a GAAP loss of \$717 million and free cash flow of negative \$812 million. But **shares rise** on Musk's claims of positive cash flow and profit in the second half of 2018, and signs of more consistent Model 3 production. In this Q2 release Tesla claimed that it would be GAAP profitable in Q3 & Q4 barring a "force majeure." I've asked **Mark Spiegel his take on this and he says that he's "run numbers every which way I can and the best I can come up with for Q3 is a GAAP loss of around \$100 million."**

1

On August 7th, Elon Musk tweeted out that he was "**considering taking Tesla private at \$420 a share,**" and then followed up with that by saying that he had secured funding.

On August 12th, **Azealia Banks** shares an Instagram story about her experience at Elon's house resembling the movie "Get Out," and suggests that Elon was possibly on Ambien or on drugs during the tweetstorm. 1 2

On August 13th, Elon followed up with a press release that attempts to explain his last tweet. 1

On August 15th, **Charlie Gasparino** reports that the SEC has begun a **probe into violations made by Elon Musk** 1 2

On August 15th, ex-Tesla employee and whistleblower **Martin Tripp** tweeted photos on Wednesday night that he alleged came from inside the company that he says show battery scrap, trailers containing battery waste, and documentation of punctured battery parts in Model 3 vehicles. Tesla denies that any punctured battery parts made it into vehicles. 1

On August 16th, a Tesla **ex-security employee** filed a whistleblower complaint with the SEC, accusing the electric vehicle maker of spying on employees, hiding significant theft of raw materials alleges theft, and drug dealing at company 1

On August 16th, Elon conducts a **tearful interview with the New York Times** 1

On August 20th, (or thereabouts) reports emerged of **Lucid Motors** (a silicon valley electric car startup) was in talks with Saudi Arabia's sovereign wealth fund for a reported \$1 billion in funding.

On August 24th, Elon Musk released a public statement and tweet that he is **keeping Tesla public** 1 2

On September 6th, **Elon Musk** does the **Joe Rogan Experience**, where he ends up smoking weed.

On September 7th, Tesla's chief accounting officer **Dave Morton** **resigns** after a month on the job. In a statement in Tesla's recent 8K filing, Morton says he left Tesla because of "the level of **public attention placed on the company.**" Dave replaced the previous **CAO**, who left in March, on apparently no notice. 1 2 3

On September 7th, Tesla's Chief People Officer **Gaby Toledano** announces she is leaving the company after announcing a leave



of absence in August. She was at the company for only a year (May 2017) 1

On September 8th, it is reported that Justin McAneer, vice president of worldwide finance and operation, is parting ways with the electric-car maker, said the people, who requested anonymity because the information hadn't been made public. McAneer confirmed his last day at Tesla will be Oct. 7 in a statement obtained by CNBC. 1

On September 17th, British diver and cave explorer Vernon Unsworth sued Musk for libel in a California district court. The lawsuit comes two months after Musk called Unsworth "pedo guy" on Twitter, following an interview in which the Brit denigrated Musk's attempt to build a mini-submarine that could rescue a group of Thai boys trapped in a cave. Though Musk later deleted and apologized for the tweet, he doubled down on the pedophilia claim a month later. 1

On September 17th, it is reported that Lucid Motors closed \$1 billion deal with Saudi Arabia to fund electric car production. 1

On September 17th, reports emerge that the justice department is investigating Tesla over public statements made by CEO, Elon Musk in a criminal probe. 1

COMPETITION

- Jaguar I-Pace electric SUV (which had already received fabulous reviews, handily beating Tesla in comparison tests) became widely available in European showrooms (and does so in November in the U.S.) at a price roughly \$13,000 cheaper than the Model X and \$7000 less than the Model S, gaps that will widen substantially as Tesla's tax credits phase out.
- Next, the Mercedes EQC was unveiled in September. This all-electric SUV will be available in Europe in mid-2019 and in the U.S. in early 2020, with an EPA range roughly comparable to that of the base Tesla Model X (an estimated 225 miles vs. 237 for the Tesla) but will cost approximately \$25,000 less, as the Mercedes should sticker at around \$65,000 and will get a full \$7500 tax credit while the Model X starts at \$83,000 and will get no tax credit when the Mercedes arrives. (By 2022 Mercedes will have ten fully electric models, covering nearly all its model lines.)
- Next came the introduction of the Audi e-Tron, an all-electric SUV with roughly the same estimated EPA range as the 237-mile base Model X but with a much nicer interior and a price that's \$8200 less before the Audi's tax credit advantage. Then when the Audi arrives in the U.S. in April (it'll be in Europe this fall) it will receive a tax credit that's \$3750 better than Tesla's (thus stretching its price advantage to \$11,950), an advantage that will grow to \$13,825 in July when Tesla's credit is reduced to just \$1875 vs the full \$7500 for the Audi.
- Next in luxury EV competition for Tesla will be the Porsche Taycan, which will be available mid-to-late 2019 with a base price will be similar to that of the base Tesla Model S, and will probably be less expensive with the advantage of the tax credit Tesla will soon lose. Hmmm, Tesla or Porsche... tough choice!



FACTS

- After December 31st 2018 Tesla's \$7500 tax credits will be cut to \$3750 for six months, then \$1875 for six months, and then goes away completely.
- Tesla had \$3.4 billion in cash and equivalents at the end of the year and raised an additional \$550 million from bonds backed by lease payments in February.
- In February Tesla released its worst quarterly earnings report ever. In Q4 (using the total net loss ex ZEV credits) Tesla lost over \$28,000 on each car it sold.
- Tesla has \$31.4 billion in combined long-term debt and battery purchase obligations. Its interest expense is at a run-rate of nearly \$600 million per year, which in Q4 amounted to \$4,884 per car sold.
- Model 3 production will be at 2,500 cars per week by the end of the first quarter, according to Tesla.
- The company expects to produce 5,000 Model 3 cars a week by the end of the second quarter.
- Tesla overtook GM last year to become the most valuable US carmaker, despite having less than 1% of GM's volume
- Car component parts account for more than 70% of a car, up from 40-50% in the early 90s, according to industry experts. Their share has grown as cars have become more technologically complex, requiring niche expertise.
- Tesla issues its largest recall ever (123,000 vehicles) over faulty Model S steering. Before this, its largest Model S recall was when 90,000 of the vehicles were affected in 2015 by a faulty seat belt. And last year, it recalled 53,000 Model S and Model Xs' over a parking brake fault.
- Tesla's debt-to-equity ratio is 243% as of Dec. 30; SolarCity's was 375.6% at time of acquisition.
- Customer deposits, which are mostly refundable, topped \$850 million at last count.

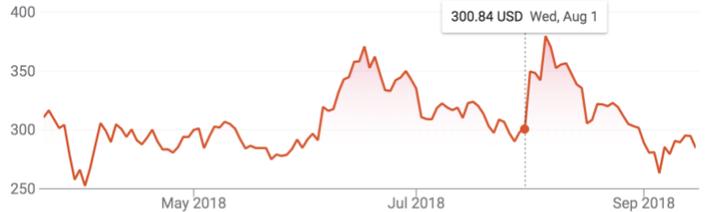
Market Summary > Tesla Inc

NASDAQ: TSLA

295.32 USD -3.70 (1.24%) ↓

Sep 20, 12:05 PM EDT · Disclaimer

1 day 5 days 1 month 6 months YTD 1 year 5 years Max



Open	303.56	Div yield	-
High	305.98	Prev close	299.02
Low	293.33	52-wk high	387.46
Mkt cap	50.27B	52-wk low	244.59
P/E ratio	-		

TSLA: August 1st – September 19th



QUESTIONS

1. **Timeline** — It feels like Tesla has always operated with some degree of controversy surrounding it. The company had its IPO on June 29th, 2010, four months after selling its first car, the Tesla Roadster. It's been in operation since the summer of 2003. **Q:** Can you give us some background on the company and the timeline of events that are relevant to understanding where we find ourselves at today? What are your biggest concerns about the company?
2. **What's the Demand?** — In a letter sent to investors in the middle of August, you write: “we believe the TSLA Model 3 (“M3”) demand story/growth narrative is materially flawed.” You have also written more recently that “everyone is focused on supply, but we feel demand is going to potentially push TSLA into crisis, as soon as Q4 of this year. We are now in Q4. **Q:** What is the demand crisis that Tesla is facing or that it will face, in your view? What has happened to demand for the Model 3? Has this had an impact on the Models S and X as well? What do you think is driving the drop in demand?
3. **How's the Quality?** — There has been constant reporting, primarily through social media, of Model 3 quality issues, including bumpers falling off, I think issues with the paint, etc. **Q:** How serious are the Model 3 quality issues, because supporters of Tesla may concede that the company could have its act together better on the financial/managerial front, but that when it comes to manufacturing they know how to make one hell of a car?
4. **Setting Expectations** — What impact has Elon's style of overpromising and underdelivering had on this stock and on this company?
5. **Subsidy Boy** — What role has the subsidy played over the years in making this company viable, and what impact do you expect that to have once it starts to quickly diminish after the end of this year?
6. **Sentiment Analysis** — How has sentiment changed over the past six months? How has sentiment changed among analysts and what has the sentiment been among the broader public? (Ex: how was Elon's impromptu appearance on the Joe Rogan Experience perceived by the public vs. the investor community?)
7. **Going Private** — Do you believe that going private may become a realistic option at some point in the future and at what price would such a deal become viable?



8. **Criminal Investigations** — We recently learned that the SEC investigation is now “wide ranging.” In your view, this suggests “that the investigation now covers a much wider range of topics, likely focused on Musk’s prior tweets (as a point of reference, and shown below, we count over 115 lies Elon Musk has told via twitter – *i.e.*, *guidance he hasn’t met*) as well as personal trading.” We also know, from a story reported by Bloomberg on September 18th that TSLA is now under “criminal” investigation by the DOJ for “public statements made by the company and the CEO Elon Musk.” **Q:** What was Tesla’s response to the story, and if true, what is the significance of a criminal investigation by the DOJ at this time? What does it usually take for the DOJ to get involved in cases of securities fraud, considering that Tesla was already under investigation by the SEC? What impact will this have on Tesla’s already impaired ability to raise capital? What accounts for the bump in the stock when the criminal probe was announced? Wouldn’t this offer institutional longs an easy out?
9. **Competitors** — How will Tesla compete against a field of entrants from established car manufacturers with more cash at their disposal and legacy combustion engine models to cushion volatility in the adoption curve for EVs?
10. **Flight of the Executives** — How significant is the flight of top executives from the company in the last few years? What does it say about potential deception of shareholders? Are we seeing insider selling?
 ***Tesla’s chief accounting officer Dave Morton resigns after a month on the job. In a statement in Tesla’s recent 8K filing, Morton says he left Tesla because of “the level of public attention placed on the company.” Dave replaced the previous CAO, who left in March, on apparently no notice.
 ***Tesla’s Chief People Officer Gaby Toledano announces she is leaving the company after announcing a leave of absence in August. She was at the company for only a year.
 ***Justin McAnear, vice president of worldwide finance and operation, is parting ways with the electric-car maker.)
11. **Range of Outcomes** — What do you see as the range of outcomes for Tesla? Do you see a path towards profitability, where Elon remains CEO and the company survives and thrives over the next X number of years? How likely is it that the company will have to declare bankruptcy when it is all said and done? What about going private?
12. **Drop it while it’s Hot** — Do you expect that, at some point, this stock is going to just start dropping and dropping without the rebounds we have seen for years?

