

The Dark Side Of Tesla's Masterful Short Squeeze

Mon, 03 Jun 2013 17:00:00, newstips66, [post_tag: 60-minutes-investigation, post_tag: autogreenblog-com, post_tag: barack-obama, post_tag: boycott-tesla, post_tag: bribery, post_tag: crony, post_tag: crony-bribes, post_tag: crony-politics, post_tag: cronyism, post_tag: dept-of-energy, post_tag: diane-feinstein, post_tag: elon-musk, post_tag: fisker-cronyism, post_tag: gao-investigation, post_tag: john-doerr, post_tag: kleiner-perkins, post_tag: kleiner-perkins-sex-allegations, post_tag: la-times-investigation, post_tag: mitt-romney, post_tag: solyndra, post_tag: solyndra-scandal, post_tag: solyndramobile, post_tag: steve-spinner, post_tag: steve-westly, post_tag: steven-chu, post_tag: tesla-cronyism, post_tag: tesla-finnicals, post_tag: tesla-kleiner, post_tag: tesla-motors, post_tag: throw-them-all-out, post_tag: tsla, post_tag: washington-corruption, post_tag: washington-corruption-investigation, post_tag: washinton-cronyism, category: worldnews]

The Dark Side Of Tesla's Masterful Short Squeeze

May 22 2013, 15:48 by: John Petersen | about: TSLA

Over the last month and a half I've watched in awe as Tesla Motors (TSLA) pulled off a masterful short squeeze and follow-on financing that has supporters dancing in the streets and fanboy bloggers making all manner of preposterous forecasts. Now that the dust has settled and the irrational exuberance has cooled a bit, it's time to take a calm and objective look at some of the dark clouds that host the silver lining.

The Light and Fluffy Q1 Profit

Anybody who can read a disclosure document knows that Tesla's Q1 net income of roughly \$11 million was a fluke that's not likely to be repeated. Tesla lost about \$91 million on its principal business activity of making and selling cars. Its reported net income was solely attributable to events and payments that are unlikely to be a reliable source of recurring future revenue including:

- \$68 million in ZEV credit sales;
- \$17 million in GHG credit sales;
- \$11 million in warrant liability reversals; and
- \$7 million in foreign currency adjustments

The demand for ZEV and GHG credits arises from laws and regulations. As long as demand exceeds supply, the credits have significant value to automakers that need them. Once supply exceeds demand, however, the credits become worthless. The following 2010 graph from the Natural Resources Defense Council shows that a crossover point between ZEV credit supply and demand will occur this year. While Tesla expects to report additional credit sales in Q2 and Q3, it has clearly stated that the game will be over by Q4 because Tesla and all the other automakers that are building zero emission vehicles will saturate the ZEV credit market.

The Whispy Financing Scheme

The issue fanboy bloggers have overlooked or chosen to ignore is the negative if not disastrous income statement impact of Tesla's new financing scheme. It's a great deal for consumers who want to drive a Model S and can't afford to write a check. It's a brutal deal for stockholders because all financed vehicle deliveries will be accounted for as operating leases.

In its discussion of the financing plan, Tesla's recent Form 10-Q says:

"As a result of the residual value guarantee, we expect to apply lease accounting to these sales which would defer the recognition of the associated revenues over time instead of full recognition at delivery."

The layman's translation follows.

When Tesla sells a car for cash it recognizes a \$90,000 sale, deducts its cost of goods sold and reports the entire gross margin in the current period. When a new car is financed, the difference between the sale price and the residual value will be spread over the 36-month contract term along with the associated cost of goods sold. So instead of recognizing a \$90,000 sale on day one, Tesla will recognize about \$3,450 per quarter for a period of three years.

Just for grins, let's assume total shipments of 5,000 cars per quarter, an average sales price of \$90,000, a gross margin of 25%, and combined R&D, SG&A and interest expenses of \$100 million per quarter. The column on the left is stated in thousands and shows how the revenue and expenses would be reported if all buyers paid cash. The column on the right shows how the revenue and expense will be reported if 20% of buyers take advantage of Tesla's financing option.

If a 20% financing take rate converts a \$12.5 million profit into a \$9.1 million loss can you imagine the impact of a 30% to 40% financing take rate?

I can't speak for anybody else, but a financing scheme that sells a few more cars but savages current revenues and net income doesn't strike me as all that wondrous. I'm sure that Tesla will do its level best to draw attention to its balance sheet and cash flow statements which may look OK if Tesla can meet its ambitious cost reduction and gross margin goals, but the ugly income statement headlines will be the first thing investors see and the first thing the market responds to.

An even thornier issue arises from the magnitude of the residual value guarantee. Under the announced plan Tesla is guaranteeing a 50% residual value on the first \$70,000 of a car's price plus a 43% of any upgrades. For a \$90,000 Model S-85 the residual value guarantee works out to \$43,600, which strikes me as quite a stretch for an entirely new product class that has no meaningful residual value history.

I've heard the arguments about EVs retaining their value better than conventional vehicles despite battery degradation issues. Those arguments generally come from ideologues that are also quick to explain why EV technology will progress by leaps and bounds in coming years while prices plummet. In my mind, the two arguments are mutually exclusive and you can't possibly have it both ways.

If the 2016 product offerings from Tesla are significantly better and cheaper than its current Model S, I have a hard time imagining anyone paying a premium price for a three-year old used car with antiquated first generation technology. Since I have a long history of changing out my computer systems every three or four years I know the pain of trying to sell the last generation so I can buy the latest upgrade.

Over the short term Tesla can assume whatever it wants with respect to resale value. When a meaningful resale market develops, as it must, Tesla's auditors will have to rely on independent evidence of residual value instead of management's estimates. If the residual value reality proves current estimates overly optimistic, the resulting write-downs to bring Tesla's balance sheet accounts into line with market realities could be huge.

The Turbulent Short Squeeze

The short squeeze began in earnest on April 1st after Tesla said it would report a first quarter profit without telling anyone that the profit was all nonrecurring fluff. The total short position was 31.3 million shares. Since April 1st an astounding 358.8 million shares have traded as short sellers closed out losing trades and opened new short positions at higher prices. In a frothy market like the one we've seen over the last several weeks, it's highly unlikely that the overall short position has changed significantly. The shorts have simply reloaded at a higher price.

At March 30, 2012 Tesla's stockholders equity was \$168.6 million, or roughly \$1.46 per share. The recent stock offering increased net equity to \$532 million, or roughly \$4.45 per share. The \$85 spread between net equity per share and market value per share represents prevailing expectations that Tesla will be a stellar performer on a go forward basis. As near as I can tell, those expectations do not account for the ugly reality that the ZEV and GHG credit cornucopia is darned near empty and Tesla's magic financing scheme will savage future revenue and earnings.

The Ominous Hype Cycle

One of my favorite market behavior graphs comes from the Gartner Group and shows the typical market value performance curve for a company like Tesla that's introducing an exciting new product to the market. Gartner calls the phenomenon the Hype Cycle. The process begins when a company emerges from the R&D phase and values climb through the early launch and glowing reports from early adopters.

Within a short period of time expectations build to a point where they become irrational. Then the little failures and disappointments start cropping up and the market starts to take a closer look at the substance behind the excitement. In most cases it's a long downhill slide from the peak of inflated expectations.

In February of this year I wrote, "At \$4 a share, Tesla would be an interesting speculative stock. At prices approaching \$40 a share it's a sucker's bet with limited upside and unlimited risk." Frankly I was amazed at both the strength of the short squeeze and Tesla's ability to strike while the iron is hot to capitalize on the event. I guess it just goes to show that some suckers bet pay off, but only if the sucker is smart enough to realize that he dodged a bullet and quit while he's ahead instead of going for the double or nothing bet.

In light of Tesla's recent financing transaction, I have to update my prior conclusion. I now believe that Tesla would be an interesting speculative stock at a price of \$10 to \$15 per share. At prices in the \$90 range it remains a sucker's bet with limited upside and unlimited risk.

Disclosure: I have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours. I wrote this article myself, and it expresses my own opinions. I am not receiving compensation for it (other than from Seeking Alpha). I have no business relationship with any company whose stock is mentioned in this article.