(LAM) LOMBARDO ASSET MANAGEMENT

Socially Responsible Investing

Rating: "6 to 7"/10 (best)

****Summary:** Tesla (TSLA) shares continue to remain volatile given the confluence of news and events including earnings reports, erratic management and headline risk. Our rating is weighed down by management (key man risk, high turnover in top ranks, very low Glassdoor ratings) and very weak governance (including aggressive accounting. Our rating is supported by Tesla's reasonable valuation, operating leverage, leading (and controversial) technologies, highly-rated product, and (albeit costly) vertically integrated business model.*

Pros	Cons
▪ Valuation, at 2x EV/Forward Revenue does not seem excessive considering the rapid growth	▪ However, Bears point to OEM Auto EV/Revenues of just 1x.
▪ I believe the company has Operating Leverage given its focus on robotics.	▪ Factory assembly lines have had several false starts, of which Musk admits was a mistake having too much reliance on robots.
▪ Expanding into large markets (China, Europe)	▪ Trump likely to get upset by the China plant ▪ The sedan market is saturated, so much depends on China.
▪ Will be introducing products/styles that are the most sought after (SUV: Model Y, pickup: Cybertruck)	▪ This will likely keep Capex higher than mgmt. forecasts. ▪ We expect R&D may need to grow to a higher percentage of revenues compared to 3Q'19's level.
▪ Autonomous and other technologies are considered leading edge by some.	▪ Some say Tesla is now lagging in Autonomous and car accidents have tarnished its image. Also, it doesn't use LIDAR which some say is a disadvantage. Consulting firm Navigant ranks Tesla autonomous low.
▪ Tesla has leading engineers, etc.	▪ Management team is known for being intense and turnover is very high. Since 2018, resignations of the CFO, Senior Director of Production and co-founder and CTO.
▪ Musk is considered a visionary	▪ **Musk is considered an unstable madman. Tesla has been subject of numerous SEC probes and several lawsuits.** ▪ **Musk runs several ventures and is considered "stretched"** ▪ **Glassdoor rating, at 3.3 is very weak. CEO approval is also terrible at 67%.**
▪ 3Q'19 Earnings Release was much better than expected. Credit risk and liquidity do not seem an issue anymore	▪ Revenues were worse than expected and Model S and X sales are decelerating sharply. Some deferred revenues were recognized during 3Q'19. ▪ **Several analysts consider Tesla's accounting to be manipulated and perhaps fraudulent**.
▪ All Tesla autos are connected to headquarters and collect real-time driving data	▪ This may be subject to privacy and litigation issues

Pros	Cons
▪ Optionality of new businesses including Ridesharing (aka Mobility platform), monetization of customer driving data.	▪ Some say Tesla lacks funding for all its initiatives.
▪ Management has vertically integrated its major technologies which it considers a competitive advantage.	▪ Few companies are vertically integrated as it's considered too expensive and lacks best of breed. It is also extremely expensive for Tesla to design its own SOC chips, etc.
▪ Credit Metrics are much better than media suggests: Net Debt/EBITDA (2018A): 2.9x. ▪ FCF went from ($4.1Bn) in '17 to ($0.2Bn) in '18. ▪ Tesla uses a conservative calculation for EBITDA (and does not add back Stock based compensation or non-cash charges	▪ However, Tesla had weak liquidity in 2Q'19 when cash + restricted cash was $2.7Bn and FCF was ($-0.9Bn) during the quarter. ▪ At that time, news media warned of a potential liquidity crises.
▪ Tesla seeks a 25% LT gross profit margin (GPM). ▪ I believe this is possible as company pivots to "where the money is" (SUVs, Pickup trucks) and uses same platform for other styles. ▪ Gross margin (ex regulatory credits) was 20.8% as of 3Q'19.	▪ Several writers including Morgan Stanley (22-23% margin in 2027-28E) are skeptical. ▪ MS has a FCF/Revenues of just 6% in 2028.
▪ Tesla has strategic value to an outside buyer (Apple, Tencent, a former large holder) or related company (SpaceX)	▪ Apple appears to be developing its own technology independently. The Trump Admin is unlikely to approve certain outside transactions.
▪ Some of Tesla's upcoming competition appears to have stalled. ▪ Some OEM (Toyota) EV programs are behind and the Chinese EV threat (NIO) has encountered challenges	▪ Given that there are two dozen OEMs (e.g.: GM, Ford, Toyota) and one dozen outsiders/tech (e.g.: Uber, Waymo) competition will likely be intense within 5 years.

***Note**: This article was originally written in November 2019