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PERSPECTIVE

The Tesla Bubble

By Jonathan Michaels

Tesla Inc. — the famed electric car company named after Serbian physicist Nikola Tesla — has done what many considered to be the impossible: It has become the most valuable car company in the nation. Last month laid witness to Tesla's stock surge to $314 per share, resulting in a market capitalization of $51.3 billion, and catapulting the company past valuations of both Ford and General Motors.

The accomplishment is no small feat. GM has been selling cars since 1908, and for 77 years it stood as the largest car manufacturer in the world. Ford was never far behind. Established in 1903, and having revolutionized industrial thinking with the invention of the assembly line, there once existed a time when one in every four cars sold in the U.S. was branded with the blue oval.

Yet none of that seems to matter, as Tesla has disrupted an industry that has enormous barriers to entry, and is steeped in tradition. Tesla had its public offering in 2010. The last American car maker to go public before that was Ford, in 1956.

The public financial climb that Tesla has accomplished is nothing short of miraculous. Its shares have rocketed from an initial offering price of $17 per share to eye-popping $314, meaning that an initial investment of $25,000 would have yielded a return of nearly $500,000. If we only knew when to invest.

Comparatively speaking, Tesla's stock price is way out of whack. GM, which is still the third largest car manufacturer in the world, trades for $34; Ford, ranked fifth in world order, sells at $11. To exemplify the point, consider that in 2016, GM sold 10 million cars worldwide. Tesla has sold 211,000 in its entire 14-year existence, making its annual vehicle production somewhat of a rounding error in real-world car making.

Then there is the matter of financial results. GM's operations yielded a 2016 net profit of $9.4 billion. Ford posted a 2016 profit of $4.6 billion. Tesla, which has never experienced a profit, stated in its 2016 annual report that it lost $773 million last year. What is worrisome is that the situation seems to be getting worse. The company's first public reporting indicates that it lost $82 million in 2008, and reportings since then indicate that its losses have increased year-over-year, with only mild deviations (its best year was a loss of $74 million, and in 2015 it lost $889 million).

If that is not concerning — and it should be — the losses are looking to become markedly worse. Last November, Tesla completed its $2.6 billion acquisition of SolarCity, a California-based solar energy company started in 2006 by Elon Musk's cousins, Peter and Lyndon Rive. Musk claims that the move will create operational synergies with Tesla, but at what cost? Like Tesla, SolarCity has been losing money at an alarming, and increasing, rate. In 2012, the company posted a net loss of $64 million; last year it lost $820 million. Had Tesla and SolarCity been combined for all of 2016, they would have experienced a collective $1.6 billion loss.

New York Times News Service

A model of the chassis of a Tesla Model S in the lobby at the Tesla Gigafactory construction site near Sparks, Nevada, July 18, 2016.

Tesla is cognizant that its financial path may be thorny for time to come. In its 2016 annual report, it acknowledged that it had experienced significant manufacture delays, and noted that if it is unable to reduce manufacturing costs of the Model S and Model X, its financial condition "will suffer."

Not long ago, Reuters reported that Tesla loses $4,000 on every car sold, calling into play the age-old colloquial line that "it will make it up in volume." Tesla disputed the report, but publishing financial statements that are flooded with red ink is not confidence-inspiring.

If its financial picture is so bleak, why is it that investors are happy to throw money at it hand-over-fist? Some speculate that the company will become the dominant force in the alternative energy space. The thought is not all that crazy.

As of the close of the first quarter of 2017, Tesla was the second largest global pure electric car manufacturer in the world (after the Renault-Nissan alliance), a position it will not likely surrender. Not only has the company established a stronghold on the segment, but consumers seem to prefer to buy electric cars from industry disrupters, as opposed to established goliaths. This fundamental truism is all too well-known by industry giant Nissan, which put enormous effort into producing an all-electric car, the Nissan Leaf, only to find that it could not eclipse Tesla's sales.

And then there is the matter of the consumer satisfaction. Year-after-year, Tesla has been far outstripping the competition in consumer satisfaction surveys — a fact that is inexplicable, considering the enormous difficulty involved in mass producing a vehicle. In February, Consumer Reports named Tesla as the top American car brand. Its cars are just well made.

Yet, not everyone is bullish on Tesla's future. Last week, Merrill Lynch cut its price forecast on Tesla shares, opining that the manufacturer's "long-term viability" was at risk. Citing the acquisition of SolarCity as a major drag on Tesla's cash reserves, Merrill Lynch analyst John Murphy believes that there are "material risks to the longer-term viability" of the company. Merrill Lynch is recommending that investors avoid the stock, expecting the stock price to be cut in half over the next 12 months.

Others pundits are in accord, noting that because the company has never turned a profit, it isn't capable of having a P/E ratio, or price-earnings ratio, the typical yardstick used for valuing a company that measures its current share price relative to its per-share earnings. Ford has a P/E ratio of 7.5, while GM is 5.6. Using fundamental securities reasoning, GM is a better buy. Because a P/E ratio cannot be calculated for a company that has never turned a profit, Tesla doesn't even rank.

Whether we are witnessing a Tesla bubble — and, indeed, whether Tesla will even remain viable — is yet to be seen, but one thing is for certain: Elon Musk has succeeded in disrupting an industry that prides itself on being impenetrable. His product is well-received, well-made, and well on its way to creating a magnificent case study on how to accomplish the impossible.

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