A Tesla Halloween Horror Story

Colm Fagan Diary of a Private Investor Update 20 17 November 2019

I have a sizeable short position in Tesla. A sharp rise in the company's share price just before the Halloween bank holiday weekend made sure there weren't many Halloween treats for me.

Short sellers are the whipping boys of the finance world. They borrow shares, then sell them on, hoping the price will have fallen by the time they have to buy them back and return them to their owners, many of whom are blissfully unaware that their shares were borrowed in the first place. The short sellers win if the share price falls; they lose if it rises.

There is a belief in some quarters that what short sellers are doing is morally wrong, that they shouldn't be allowed to bet on share prices falling. I once shared that view. A series of events eleven years ago caused me to change my mind.

In 2008, St Patrick's Day fell on a Monday. It was a bank holiday in Ireland, but the short sellers who chose that day to target the Irish banks were hard at work. In what came to be known as the St Patrick's Day massacre, they short-sold the Irish banks, causing their share prices to collapse. Worst hit was Anglo Irish Bank, the poster boy of Ireland's property boom.

Official Ireland went apoplectic at what it claimed were faceless, unscrupulous profiteers who had the effrontery to question the stability of the Irish banks. Regulators, politicians and bank bosses took to the airwaves, insisting that the banks were absolutely safe, that there was no need to worry.

The reprieve was short-lived. Within months, the short sellers were proved right. Anglo Irish went bust; the other banks went cap in hand to government, begging for bailouts. Their shareholders were wiped out. Taxpayers had to foot the bill for rescuing their depositors. The short sellers were the canaries in the coalmine who had warned of impending doom. If politicians and bank regulators had heeded their warnings a few months earlier, Irish taxpayers would have been saved billions.

This episode caused me to change my mind about short sellers. No longer the baddies, they were now the good guys; heroes, not villains. With the zeal of a convert, I was ready to short-sell companies I thought were overvalued.

Tesla, the electric car company, was a prime target. I had long believed that its shares were grossly overvalued and had backed my judgement by shorting it. By the end of May this year, I was feeling smug. For every 100 shares I had shorted since opening my first short position in the stock in January 2018, I had closed 83, pocketing an average profit of $25 a share. The other 17 of every hundred shorted shares still outstanding were now priced in

the market at $185 each, and I was sitting on a paper profit of $122 a share compared with the average $307 at which I had opened the short positions. Looking back now, I don't know why I didn't close my short positions entirely when the price fell below the $200 target I had set myself some time previously. It's too late now. No use crying over spilt milk.

The window of opportunity didn't remain open for long. Soon, the price was back above $200. Now that the price was above my target, I decided to increase my short position again. For every 17 open shorted shares at end May, I added another 28 at an average of $242 a share.

At the start of last month, Tesla's share price had risen to more than $240, but I wasn't worried. I could still close my entire position at a profit, but that wasn't enough for me: I wanted more. The results for the third quarter would be released in a few weeks. I was confident that they would disappoint the bulls and please the bears like myself. The market would realise that I was right; the share price would fall; I would bag a handsome profit and ride off into the sunset, my satchels filled with gold.

Except that things didn't quite work out as I had hoped. The third quarter results were released after markets closed on Wednesday 23 October. I reviewed them briefly that night and felt vindicated: revenues were down 8% from the same quarter in 2018; operating expenses were down 16%, mainly due to an 18% reduction in selling, general and administrative expenses. Spending on research and development was also down, by a smaller percentage. It seemed to me that Tesla was behaving like an outdated industrial metal-basher that was fighting off bankruptcy, trying to squeeze costs as revenues fell. It was definitely not living up its billing as one of the world's great growth stories. I thought the market would agree and that the share price would fall when stock markets opened the following day.

I got it badly wrong. The share price jumped more than $40 on Thursday and another $30 on Friday, the start of the Halloween bank holiday weekend in Ireland. There was no need for ghosts or ghoulies to make it a scary Halloween for me: losing $70 a share in just two days was more than enough to send shivers down my spine.

I still don't understand why the share price rose so sharply after the results. I eventually concluded that other investors had interpreted the expense reductions in Quarter 3 as evidence of improved efficiency, not as desperate cost-cutting, which was my interpretation. Undoubtedly, the cost reductions transformed the bottom line: net income in the quarter was $150 million compared with a loss of $389 million in the previous quarter.

As an old finance man, one of my favourite sayings is "Revenue is vanity; profit is sanity", so I should have been impressed by the turnaround in net income despite the fall in revenues. This time, though, I suspect the opposite is true, that Tesla's failure to grow its revenues at anything approaching the rate needed to justify its current valuation will eventually bring the share price down to earth.

Its growth ambitions are not helped by the decision to cut spending on research and development (R&D), which for most businesses is the engine that drives future revenue growth. R&D expenditure was over $100 million lower in the first nine months of 2019 than in the same period of 2018. Tesla's R&D spend is less than a tenth that of Volkswagen.

Tesla's current valuation, based on today's $350 share price, is $63 billion. That's a lot of mouths to feed. In addition, there is the $13 billion owed to bondholders and the expensive share options to CEO Elon Musk and his top managers if the business succeeds. In order to justify that valuation, a mature Tesla would need to be churning out profits of €2.5 billion a year, after deducting interest payments on its massive borrowings. That's a tall order for a company that lost almost $1 billion in the first nine months of 2019, much the same as it lost

in all of 2018, and whose grand ambitions are not being backed by the necessary investment in research and development.

Based on that analysis, I think my wager is safe in the long-term, but I am haunted ever since that Halloween weekend by the quote attributed to the great economist (and keen private investor), John Maynard Keynes, who famously wrote: "The market can stay irrational for longer than you can stay solvent."

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PS: Elon Musk enjoys sending consignments of shorts to Tesla's critics when the share price rises after a results announcement. Elon, if you're reading this, I have a 36-inch waist, reducing to 34 if Tesla's share price goes higher.