PANTERA

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Dear Partners,

I bought a Tesla Model S last year. Like Victor Kiam, who used to advertise Remington razors on television by saying, "I liked it so much, I bought the company", I bought the stock. My car was beautiful, fast, silent, comfortable, technically fascinating, and cost almost nothing to operate and maintain. I've taken it on several long trips, rarely finding range an issue. My only problem was with how many people stopped me to ask about the car. No wonder it is now outselling the Mercedes S-class, BMW 7-series, and Audi A8. The Model S isn't just for Silicone Valley nerds.

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I asked Ron Glantz, my partner from Pantera days, to look at the stock as a securities analyst. Ron had been elected the best automobile analyst on Wall Street for seven consecutive years by investors polled by *Institutional Investor* magazine. One of our first trades at Pantera was to short GM, Ford, Chrysler, Eaton, Dana, and a few other large domestic suppliers, holding several of them until they went bankrupt.

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RON'S TAKE ON THE CAR

Ron went to Menlo Park for an hour-long test drive and then literally followed several Tesla drivers home to quiz them about the car. While the limited number in his sample isn't statistically significant, everyone was a "fanboy", ignoring shortcomings ("too wide to park in my garage", "doesn't have important features, such as back-up warning, memory seats, and adjustable thigh support", "rear visibility is poor", and "insufficient headroom"). And every single owner Ron interviewed had bought TSLA stock.

Ron was impressed with the Model S, and said he would buy the smaller next-gen model if it met Elon Musk's objectives. He viewed the Model S's shortcomings as having come primarily because the company is run by visionary engineers, not bean counters or Detroit lifers, and most of the complaints about missing features could be easily fixed by suppliers.

RON'S TAKE ON MANAGEMENT

After having met so many genuinely dumb auto company executives, Ron was pleasantly surprised by both Tesla's strategy and how well executed it has been. Unlike most other electric car startups, Tesla introduced its first models at the high-end of the market, where margins were generous and buyers were less concerned with range (they could just use one of their other cars). The Model S is a spacious five-door with luxurious appointments and an optional rear-facing third row. Unlike Fisker, the only other start-up to concentrate on high-end cars, Tesla put a heavy emphasis on R&D. While Teslas have had teething problems, none of their cars, unlike the Fisker Karma, caught fire.

Other good moves:

- Hired a designer from Jaguar to develop a beautiful car (the Model S bares more than a passing resemblance to the Jaguar XF).
- Bought non-critical components from suppliers, reducing overhead, but kept critical components (such as battery management and assembly) in house, where they could be closely monitored, a decision Boeing wished that it had made with its Dreamliner. Tesla also stamps its own aluminum sheet metal, injection molds its own bumper covers, winds its own motors, and upholsters its own seats.
- Replaced mechanicals with electronics as often as possible, giving the car a "wow" factor. For example, while even the Prius offers a key fob that automatically unlocks the car when the driver approaches, Tesla went one more. The Model S has a handle mounted flush with the door, which improves aerodynamics and reduces the ability of crooks to steal the car. However, the main value is its effect on potential buyers, as approaching the car with a fob causes the handle to silently extend. The dashboard has just two visible physical buttons (for the hazard lights and to release the glove box door). Most gauges were replaced with touch screen controls. While touch screens often lead to consumer frustration (e.g., MyFord), Tesla offered a mesmerizing 17-inch screen (four to six times larger than its luxury car competitors) with the ability to put several pieces of information on the screen at the same time, access to the latest Google maps, and overnight downloading of software updates over its cellular connection. This enabled Tesla to quickly overcome early software problems, such as excessive overnight battery draw.
- Partnered with Panasonic, which supplies Tesla's batteries and has invested in the company. Tesla uses a battery similar to the mass-produced batteries used in laptop computers, significantly lowering costs compared with the purpose-built batteries used in the Nissan Leaf and other electric cars.
- Emphasized internally-developed technology that was sufficiently impressive that both Mercedes and Toyota invested in the company and use Tesla for key components for its own battery-powered cars, such as its battery management system. For example, Tesla has superior cold weather efficiency than other electric cars. The Model S loses 11-12% of its range during the winter compared with 50% for the Nissan Leaf and Chevrolet Volt.
- Rapidly deployed internally-developed Superchargers, alleviating range anxiety, and periodically reduced the amount of time it took its Superchargers to charge. Superchargers provide half a charge in about 20 minutes. While there are currently only nine stations, they are expected to be in most metropolitan areas this fall, permit coast to coast travel this winter, cover 80% of the U.S. population and parts of Canada by the end of 2014, and over 98% of the U.S. population and parts of Canada by the end of 2015. Stations will be most frequent on well-traveled routes, with no more than 80-100 miles between the closest stations — well within the range of any Tesla vehicle. Tesla recently signed an agreement to put them in five malls, giving drivers the opportunity to eat or shop while waiting for their cars to charge.

Without any "legacy costs", Tesla bought manufacturing facilities for pennies on the dollar, staffed them with non-union workers, and avoided having to sell through dealerships:

- The company initially planned an assembly facility in Albuquerque, NM, with construction to begin in April 2007, and announced a separate Greenfield factory to be built in San Jose, CA. However, it didn't do either of these. On May 20, 2010, Tesla and Toyota announced a partnership to collaborate on the "development of electric vehicles, parts, and production system and engineering

support". This included Tesla's partial purchase of the former NUMMI plant in Fremont California for the bargain price of just $42 million and subsequent purchase of $17 million worth of manufacturing equipment and spare parts.

- There are substantial cost advantages to not having a dealer network, such as eliminating dealer advertising and not having to pay huge sums to do away with redundant dealerships. In fact, Tesla has not yet had to do any advertising.

By using a purpose-built car, the Model S has an aerodynamic 0.24 drag coefficient, the lowest of any production car, and avoided direct comparison with gasoline-powered cars (one of the problems with the Volt, which is based on the Cruze). Aerodynamics are helped by the Model S being battery powered — its grille inhales only one-third as much air as a standard car and its underside is quite smooth, thanks to front and rear belly pans, no exhaust pipes, and the flat battery pack under the passenger compartment.

The battery pack is roughly five fee wide, eight feet long, and four inches thick. The width and length were necessary to provide sufficient power while keeping the car low slung, one reason why the Model S is so wide. It holds 6,000-8,000 cylindrically-shaped lithium-ion cells. Liquid cooling circuits keep the driveline and battery pack within desired temperature limits during strenuous driving.
The top-of-the-line $87,400 Model S Performance model's battery weighs 1,323 pounds with a capacity of 85 kWh, roughly three and a half times the juice of the Nissan Leaf's battery. These electrons energize a 416 hp motor, which provides performance similar to V-8 German luxury cars (0 to 60 mph in 4.2 seconds, a quarter mile of 13.3 seconds at 104 mph, and a governed top speed of 134 mph). Unlike conventional cars, acceleration comes on immediately, shoving drivers into their seats.

While impressed with the car and the company's prospects, Ron thought the stock was ahead of itself, but with little likelihood of falling to a more-attractive price because it was held by so many "fanboys", people who thought that Elon Musk was the next Steve Jobs and that Tesla was the next Apple. More important, a huge short interest meant that the stock could run up during a short squeeze, similar to what happened in 2008 with Volkswagen.

SHORT SQUEEZE

TSLA exploded in price in April (from $37.89 to $53.99), after Elon Musk, TSLA's chairman, on March 31 announced via Twitter that the company would be profitable in the first quarter of 2013. In mid-March, shorts equaled 44% of the shares outstanding. (Anything over 20% is considered fuel for a squeeze.) Short interest "fell" to 42% just before first quarter earnings were reported, but that was because the interest paid on TSLA shorts reached an incredible 85% following the mid-March peak in short interest. (Normal rates are well under 1%.)

FIRST QUARTER EARNINGS

The stock surged from $55.79 at the market close on May 8 to $92.25 at the close on May 16 after the company reported $11 million in first quarter earnings. Short covering had to be a factor in this run-up as well, considering that:

- Musk had already announced that the first quarter would be in the black.
- TSLA would have been significantly in the red without selling zero-emission credits to other manufacturers.

The company reported net income of $11 million on total revenue of $562 million. However, it earned $68 million from selling Zero-Emission Vehicle credits (which it earns under California state laws governing

vehicle emissions) to other automakers, $17 million from selling Greenhouse Gas emission credits, $11 million in warrant liability reversals, and $7 million in foreign currency adjustments. While investors, the media, and security analysts were excited by Tesla's 17.1% gross profit margin, gross margin would have been only 5.7% without the ZEV credits.

Take away the revenue sources that are a byproduct of Model S sales — both enabled by legislation, as a testy OpEd in the *Wall Street Journal* pointed out — and the financial adjustments, the company lost $91 million on building and selling its cars (along with building and selling powertrains for so-called "compliance cars" to other automakers).

As an aside, while Zero-Emission Vehicle credits aren't going away (there is no cost to the California tax payer), they are sufficiently expensive that most automakers are developing compliance cars to avoid them. And obviously warranty liability reversals and foreign currency adjustments are one-time extraordinary credits.

Enthusiasm over first-quarter earnings was boosted by *Consumer Reports* giving the Model S a rave rating in its July issue, released to the media on May 9, the day after earnings were reported.

RECENT PERFORMANCE

Tesla stock kept moving up, to over $100 in June, buoyed by announcements that the company would:

- Reduce the cost of its service program.
- Offer the equivalent of leases through U.S. Bank and Wells Fargo, with the three-year residual value percentage guaranteed to be the best of any high-volume premium Audi, BMW, Mercedes, or Lexus sedan, with billionaire Elon Musk personally standing behind the guarantee.
- Build up its store network in Europe in anticipation of launching sales this summer.
- Expand the number of Supercharger stations from eight at the beginning of the year to 100 by year-end, permitting coast-to-cost driving.
- Each Supercharger station is estimated to cost $300,000.
- Give owners free use of Superchargers forever.
- Make Superchargers available for other electric cars, but for a fee (it has been more profitable to be Chevron than GM, and Tesla has a huge first-mover advantage).
- Repay its government loan early. (Tesla took advantage of the short squeeze in its stock to raise more than $1 billion in fresh equity in mid-May, using $452 million of that money to pay off its entire low-interest loan from the U.S. Department of Energy.)
- Offer a 90-second battery swap for long drives at its supercharger stations (for $60-80, a price similar to filling up a luxury car gasoline tank and providing that the replacement battery was swapped back for the original at a subsequent date). Each swap facility is estimated to add $500,000 to the cost of a Supercharger facility.

Fanboys ignored negative news, such as a recall, a decision to stop disclosing its quarter-end order backlog (after previously trumpeting a 15,000-unit reservation list) and only release sales quarterly, and postponement of production of the Model X (a sport utility vehicle based on the Model S platform) to the end of next year.

WHAT IS THE STOCK WORTH?

Until new capacity and new models come on stream, Tesla is unlikely to match the $0.12 in EPS it reported for Q1 2013 until Q4 2014 or Q1 2015. In addition to the first quarter benefitting from several unusual items and the front-loading of ZEV credits, future earnings will be hurt by delayed revenue recognition resulting from the application of lease accounting. Tesla estimates the current take rate on its recently-announced financing program as approximately 25% of sales in the U.S., and this is expected to go up to 50% in a few years. (Other high-end luxury cars have lease rates of about 85%.) While this program is not a lease per se, TSLA is required to use lease accounting. The negative impact on revenues should go from just under $400 million in 2013 to almost $600 million in 2014, moderating in subsequent years.

New models are the keys to Tesla's success, and improved battery technology is the key to success of lower-priced models. Current U.S. order rates seem to have stabilized at around 20,000 units on an annual basis. In the short-term, demand will increase as the company expands into Europe and Asia and removes anxiety range by extended its Supercharger network. Nevertheless, this suggests Model S demand of no more than 40,000 units, insufficient to justify its current $12 billion market value. To ramp up to 40,000 units only requires a second shift, and to 50,000, only $25-50 million of additional capital spending.

MODEL X

The next Tesla will be the Model X, with the company's website promising deliveries in 2014. While it is marketed as an SUV, it really is closer to a minivan. Based on the Model S platform, the X will be offered with optional dual motor all-wheel drive (the second motor will replace the "frunk" in the front of the S), permitting all-weather, all-road operation and "outperforming the fastest SUVs and many sports cars."

A unique feature of the car are the so-called "Falcon Wings", which open up and out of the way in even the narrowest of parking spots and permit passengers to step, not climb, into the vehicle. This will be a boon to parents trying to maneuver their kids into child safety seats.

SMALLER CAR

Musk said a new, smaller Tesla will go into production in late 2016. If history is any guide, the design will likely be unveiled sometime in 2015. Musk has said the Generation III car will have "a family resemblance" to the Model S.

The new model is planned to cost roughly half of what a Model S does, with Musk acknowledging that the large luxury sedan is "too expensive for most people." Price estimates have ranged from $30,000 — technically half of the now-canceled 40-kWh, $59,900 version of the Model S — to less than $40,000.

Tesla is almost certainly quoting post-incentive prices for the lower of those numbers. Even by 2016, it seems unlikely that the company will have built the 200,000 vehicles that trigger a wind-down of the $7,500 Federal purchase incentive. However, investors should note that if Tesla is successful, this incentive will disappear by the end of the decade.

Tesla has said nothing about its battery technology for the new vehicle, but we know that its cell partner and part-owner Panasonic continues to work on more energy-dense cells and cost reductions for high-volume cell fabrication.

Musk said at the annual meeting that it is working with Panasonic on new chemistry for cells optimized for use in electric-car applications. He said he was "pretty optimistic" that the necessary advances in battery technology are achievable without "any miracles happening."

BATTERY COST

Will lithium-ion battery costs fall enough by 2016 to enable Musk to fulfill his promise of a Tesla electric sedan with a 200-mile range that costs $30,000 to $40,000, only half as much as the Model S, justifying its current stock price. At $109, the stock price is a bet that Tesla can sell hundreds of thousands of cars a year once it launches its third-generation car in late 2016. This would require breakthroughs in battery technology.

The pace of battery-cost declines is one of the most-debated topics in the electric-car world. Over the last two decades, small-format lithium-ion cell costs have fallen an average of 7% annually. It's not steady progress; the declines come in a series of "stair steps" as new chemistries and new production processes are introduced and production volume rises.

So everyone expects costs to fall, but the question is, by how much?

- Morgan Stanley analyst Adam Jonas says battery-pack costs should fall from $400 per kilowatt-hour (kWh) to $200 by 2016.
- GM's Bill Wallace is quoted pegging the improvement at 20% over "the next few years," with an outside chance that the decline could be as high as 40% in five years if new technologies pan out.

In comparison, TSLA believes that the cost per kWh will decline to less than $100 over the next 10 years.

A $400-per-kWh "price" seems to have been widely accepted — perhaps because it is still much less than what competing Nissan and GM appear to be paying. This suggests that a Model S with 60 kWh in capacity (and an official EPS range of 208 miles) has a battery that costs $24,000. The 85 kWh version has an official EPS range of 265 miles, with a battery supposedly costs $34,000. However, Ron believes that the actual cost of the lithium-ion cell uses in its packs is already less than $200 per kilowatt hour, and is likely to be less than $150 by the time the next generation car enters production. This suggests that the cost of a 60 kWh battery would be only $9,000; the 85 kWh battery, $12,750. More important, the cost of the 40 kWh battery likely to be used in the Gen III would be only $6,000, only a few thousand dollars higher than the cost of the turbocharged 2.0L engine, ignition system, exhaust system, etc. used in the Audi A4.

In contrast to every other automaker, which use specialized large format Li-Ion cells, Tesla's battery pack is made up of thousands of inexpensive commodity cells similar to those found in laptops. Unlike automotive cells, these cells are produced in the billions, subject to the fierce competitive pressures that are a signature characteristic of the computer and consumer electronics industries.

Even including the cost of the battery pack enclosure, connections between cells in modules and modules in the pack, sensors, and circuitry, Tesla has significantly lower pack costs than any other maker of plug-in electric cars.

For the Model S, Tesla redesigned what was already a relatively simple cell to be much less complex and to have a much lower manufacturing cost — largely by removing expensive safety systems built into each individual cell.

When used as a laptop battery, each cell requires a safety mechanism to prevent fires. But in a large, electronically-controlled, liquid-cooled battery pack like the one used in the Tesla Model S, having certain safety features on each cell would be redundant.

TSLA's cell design eliminates the relatively complicated battery cap of the commercial cell and replaces it with a simple aluminum disk. Having radically simplified the cell, Tesla then designed simple and inexpensive fireproofing systems into its battery pack. Among many innovations, Tesla appears to have

incorporated a form of intumescent goo that it sprays onto the interior of the pack to aid in fireproofing. When exposed to heat, a chemical reaction occurs in the goo that helps cool the heat source, while simultaneously swelling to form a fireproof barrier to protect the rest of the pack.

In testing by Tesla, this material often cooled cells experiencing a runaway reaction — to the point that many failed to ignite at all — and provided a fireproof barrier surrounding those that ignited. The potential safety advantages of Tesla's small-cell approach were highlighted during the Boeing Dreamliner battery fire fracas. It can be quite difficult to cool large-format cells efficiently, and even harder to contain them once they do ignite. Thus far, Tesla has never experienced a battery fire in a production pack.

But even without the simplified design Tesla created, the standard Panasonic NCR18650A 3100mAh cells that Tesla uses probably don't come close to costing it $400 per kWh. In 2009, when Tesla started design work on the Model S, the cost for 18650 cells was already estimated at $200 to $250 per kWh. As of the third quarter of 2012, when Model S production began, prices had already fallen to $120 to $200 per kWh.

An extensive review of advertised prices for these cells from Chinese wholesalers shows that the price collapse reported last year may well have accelerated. Because these suppliers will only provide their lowest price quotes to deep-pocketed industrial buyers, and because prices change from day to day, much uncertainty remains over current prices for these batteries.

The Panasonic cells that Tesla uses are advertised with "best pricing" that ranges from $0.80 to $2 and up per cell. For context, a Panasonic 3100mAh cell at $2 represents a per-kWh cost of roughly $180.

Further evidence of a widespread collapse of prices can be seen in prices for generic Chinese Ultrafire 4000mAh cells. Even in small quantities, these cells are only about $75 per kWh, including free shipping to the U.S. While these cells are from a generic brand, they are much more energy dense than the 3100mAh cells that Tesla uses — and could theoretically represent next-generation technology. It is not implausible that extremely inexpensive cells like these exert continued downward pressure on prices of the less-advanced but higher-quality 3100mAh cells that Tesla uses.

The market for lithium-ion cells is fundamentally a black box. Only companies that purchase huge quantities of these get the lowest available prices. Depending on which battery-pack size it builds, Tesla uses about 6,000-8,000 cells per pack. Because it is now building over 400 cars per week, that would be in the neighborhood of three million cells per week. In fact, it's likely that Tesla Motors is one of the largest buyers of these cells in the world. By the end of June, Panasonic will have delivered 100 million automotive-grade lithium-ion batteries to Tesla.

In addition, the company's simplifications to its cell design likely saves a fair chunk of change. It's not unreasonable to think that less advanced, but high-quality 3100mAh cells are now indeed selling for $2 per cell (or $180/kWh). If the cheaper Tesla-designed cap saves even a dime per cell, that would cut the price to around $170 per kWh. Given clear indications that prices for 18650 lithium-ion cells have continued to collapse, $170 per kWh might even be too conservative an estimate.

OTHER TECHNOLOGY

Tesla CEO Musk has hinted that the new line might have some elements of autonomous driving, but suggested those might not be offered right at the launch. With Tesla and its Silicon Valley neighbor Google working together, these elements might be based on Google’s research into self-driving cars.

COMPETITION

If the next generation model can come to the market at under $40,000 with a 200 mile range, there doesn't seem to be much question that it will sell well. However, what happens when the $7,500 credit goes away? How will a car costing under $48,000 do? While Ron suspects that Tesla can keep the price under $40,000, which would be competitive with similar vehicles from BMW, Audi, and Mercedes, what will the reaction be of other manufacturers?

While Tesla has a first mover advantage, the fact of the matter is that other manufacturers are rapidly working on their own electric vehicles. Much of this is dictated by California, which wants 1.4 million EVs and plug-in hybrids on the road by 2025. Up until recently, California's regulations seemed like a pie-in-the-sky dream with a far-away deadline. That changed in 2011 when CARB (California Air Resources Board) mandated a combined 7,500 zero-emission vehicles be sold between 2012 and 2014 by the large automakers in the state. (Credits and trades are not included in that number.) Come 2018, smaller companies like Volvo, Subaru and Jaguar will have to embrace plug-love ***and*** *at the same time,* most of the green credits go out the window. By 2025, if my home state has its way, 15% of new cars will be an EV.

More important, Tesla's success will draw in competition. Can other manufacturers ignore a well-capitalized interloper? What will then happen to margins?

Ron's net conclusion is that he is excited about the future of battery-powered cars, but, as a fundamental analyst, thinks that the stock is far ahead of itself. As an investor, however, he can't see much downside risk, as the stock is largely owned by fanboys who ignore problems and become excited over every piece of good news. The Model X should be a huge success, almost doubling the company's volume, and the Gen III would well double volume again.

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Please contact me at 650-617-3316 if you would like to discuss.

Regards,

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Note 1: The Benchmark represents the unweighted average return of Hedge Fund Research Global Macro Index (HFRX), CSFB/Tremont Global Macro Index (INVX), and CISDM Global Macro Index.

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