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MARKET COMMENTARY

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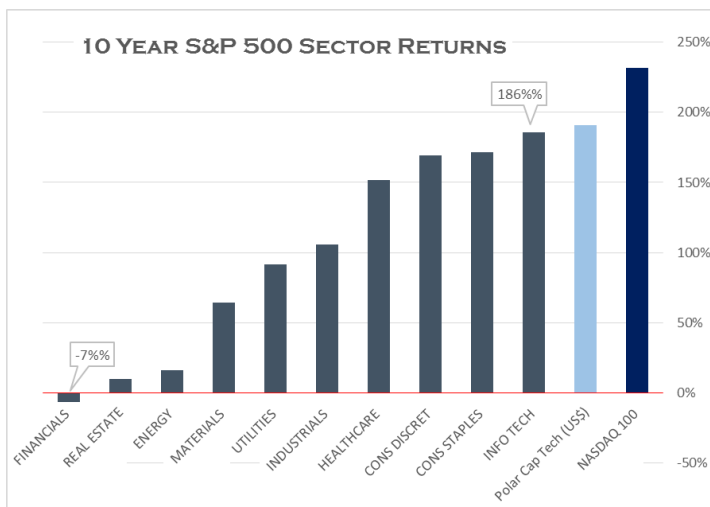


Weighing Up Tesla

May was another strong month for equities, with gains across the board as investors continued to eschew any bad news and focus on the positives. Fixed-income assets were broadly flat despite firmer expectations of higher interest rates during the course of the year in the US. Elsewhere last month there is little of significance to comment on other than to note that of all of the assets on our radar, UK property is beginning to stand out as a major laggard

The tech-heavy NASDAQ-100 hit another all-time high and is now up by 19.6% for the year, compared to 8.6% for the wider S&P-500 index. The leading gainer is Vertex Pharmaceuticals, up 68% following positive trial data on what could be a breakthrough cystic fibrosis drug. In second place is computer game publisher Activision Blizzard up 63% due to excitement building over the emerging new product pipeline.

We have been bullish on the prospects for the technology sector for as long as we have been in operation and as the chart indicates, this has been the right call over the last 10 years. Indeed, the range of returns shows how important sector selection is to a fund manager: the opportunity costs of being wedded to banks or oil companies over the period will have been significant



We were attracted to the potential for earnings growth that simply could not be offered elsewhere. Furthermore, valuations have proven reasonable and despite the recent move, the 2017 year-end price/earnings ratio of 19.4x does not look expensive relative to the S&P-500 (excluding IT and telecommunication services sector) on 18.7x and [plenty of analysts agree](#). That said, there are undoubtedly pockets of hype and this comes with the territory. The job of a good analyst is not only to sniff out the winners but to avoid any bursting bubbles.

So what should be made of [Tesla](#)? It is the third best performer up 59.6% year to date and the shares ended the month at a new all-time high of \$264, compared to the issue price of \$17 in June 2010. For the benefit of the unacquainted, the founder and CEO is 45 year old [Elon Musk](#), a software developer from South Africa who made his name as one of the founders of PayPal, the online money transfer specialist, bought by eBay for \$1.5bn in 2002.

He has since gone on to develop a range of advanced battery-powered vehicles that are rapidly moving into mass production. As we discuss further below, Musk and his credibility (or otherwise) is central to the investment case.

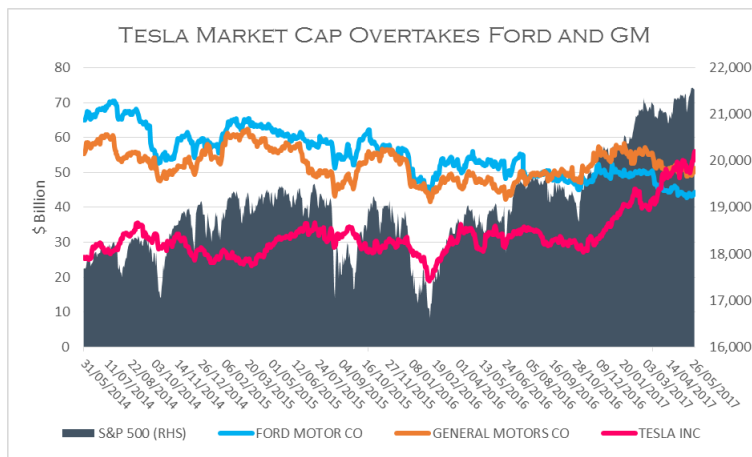
The top-end [Model S P100D](#) claims to be the quickest production road car and with all the extras has a price tag pushing \$200,000. In the correct configuration, can travel 0-60mph in less than 2.3 seconds and Tesla call this the '[ludicrous mode](#)'; having experienced it first-hand, the term is entirely fitting. The range is around 400 miles, which is enough for most drivers and the cars are undeniably beautifully kitted out. Despite the eye-watering price tag, there is some comfort in the fact that the cost of 'filling up' the car is negligible, there is no road tax or congestion charge and that there are [huge tax breaks](#) for new purchases. There is also a [Model X](#) four wheel drive, which has trademark 'falcon wing' doors.

The company's key competitive advantage is the battery technology and Tesla appears to have a substantial lead on the competition. Also, and increasingly of interest to consumers, is the cars' self-drive capability. With dozens of sensors and cameras, Musk expects to be able to drive from LA to New York without any human intervention before the end of the year and in two years, the 'driver' will be able to sleep at the wheel. One of the plans is that the owner could, say, drive to work, jump out and then let the car drive itself out as a taxi/hire car for the day, returning at hometime having earned its keep during the day. Musk says that that is '100% what will occur, it is just a question of when'.

But first things first and the company is entering a crucial phase in its development with the launch of the eagerly anticipated [Model 3](#). Arguably it doesn't look dramatically different to the Model S, although the specs are likely to be a little more comparable to existing cars, with a range of around 200 miles. Priced at \$35,000 this is aimed for the mass market and reservations are being taken now in the UK at £1,000 per car, limited at two per person. We expect that the total number of reservations must now be over 400,000 however, manufacture is yet to commence, full specifications have not been released and deliveries are still over a year away.

Yet the share price has climbed so high that with a market capitalisation of \$56bn, it is now worth more than GM and Ford, as seen in the chart at the top of page 3. So far this year, according to [Automotive News](#) GM have sold 1.17m vehicles, Ford 1.07m and Tesla 0.022m (22,000). Clearly the shares are moving in anticipation. Musk concurs that the valuation is 'absurd' if one looks backward, but of course the share price is looking well into the future.

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In an attempt to put this into perspective, if Tesla can demonstrate that by early 2019 the company is capable of producing 500,000 units at an average selling price of \$44,000 on a net margin of 10% then applying a market 25x price/earnings ratio would value the company at \$55bn, which, give or take, is where we are now. In which case it is quite plausible that the company can grow into its valuation and to be fair, these numbers are broadly consistent with what the company is saying. If one looks further out to 2022 when they aim to produce a million vehicles then further upside looks achievable and one leading analyst sets out why he sees the share price exceeding \$500 [here](#).

The point is, the Tesla story is not all about cars and Musk knows this. It's also about [trucks](#) and [solar roof tiles](#), power cell [gigafactories](#) and secret projects. When talking about the company and its plans he is evangelical and his enthusiasm is infectious. In a recent interview, he opened up on some of the projects being looked at including ambitious plans for a subterranean [network of tunnels](#) in LA for cars. This needs to be seen to be believed, but the slick manner in which the theory is presented makes the whole scheme eminently plausible.

However, many analysts see this as a cynical ploy on Musk's part. By tantalising investors, the share price is kept high, new fundraising exercises go smoothly and everyone is happy. But there are only so many times that this can work and as soon as sales targets are missed, as they have in the past, then investors will go back to the fundamentals and this means one thing for the share price – a sharp fall. In fact Tesla is one of the most shorted stocks on NASDAQ, in other words, investors are betting against it. This includes James Clunie, manager of the Jupiter Absolute Return fund who says [here](#) that “probabilistically ... the stock looks overpriced” but also worryingly goes on to touch on “corporate governance problems and aggressive accounting”. Elsewhere, Hyun Ho Sohn, Global Technology Portfolio Manager at Fidelity acknowledged the company as “an obvious leader in the industry, but ... I am not convinced that Tesla could deliver profits when they reach scale”. Interestingly at Henderson there is disagreement with the technology fund focused on the fundamental valuation which they see as being “too stretched”. The team running the Socially Responsible Investments Fund look beyond this and they have picked up on the one word change to their mission statement in July last year, shown top right.

About Tesla

BEFORE

About

Tesla's mission is to accelerate the world's transition to sustainable transport.

About Tesla

NOW

About

Tesla's mission is to accelerate the world's transition to sustainable energy.

They say that “In short, the company is no longer just a car company. It wants to displace the entire fossil fuel industry and create a solar electric economy where Tesla customers generate their own solar power, store it in Tesla Powerpacks and drive Tesla electric cars. It also wants to displace Uber by rolling out a fleet of autonomous Model 3s in cities – nothing of this is reflected in our estimates.” James Anderson, manager of the technology-focused Scottish Mortgage Trust is similarly enthused and his short video [here](#) gives a good flavour of the level of investor optimism.

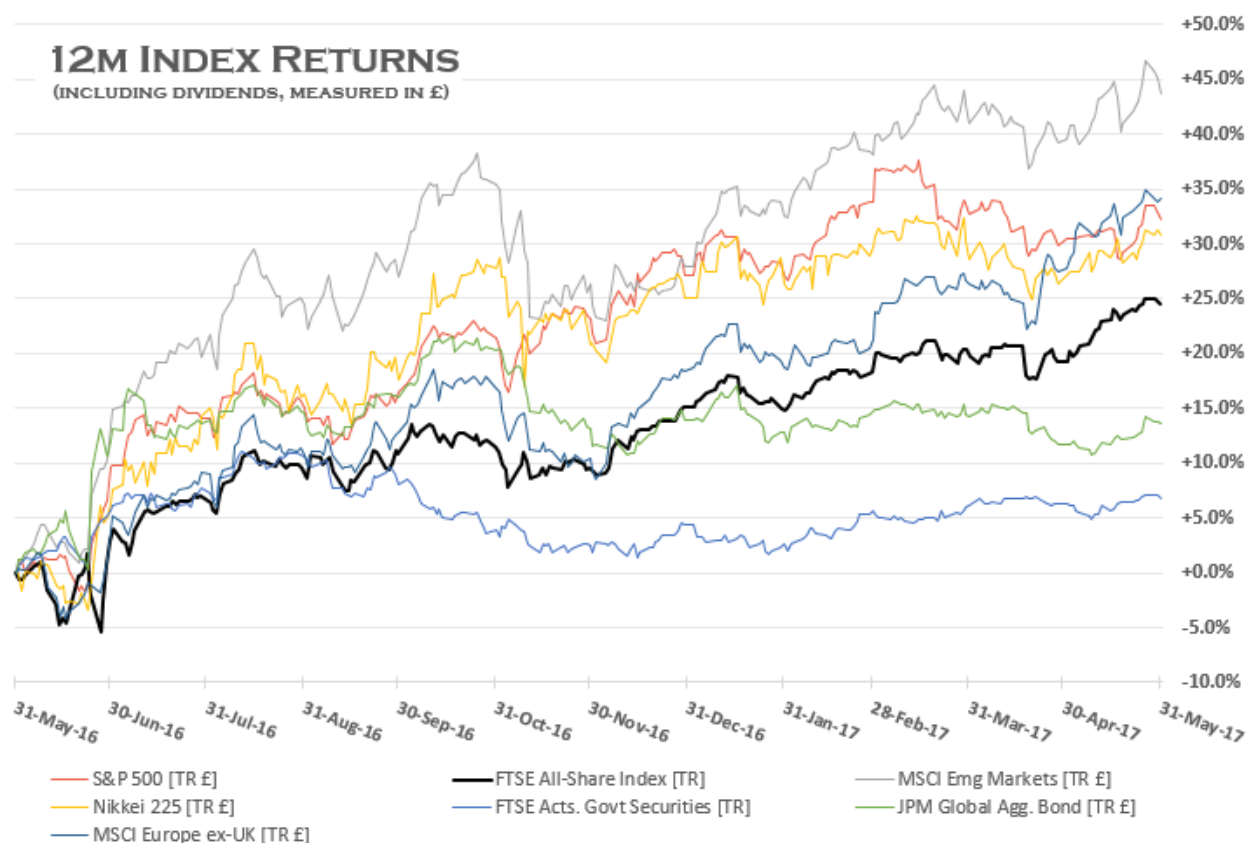
So after all that, are the shares worth buying? We would say yes, but only as part of a diversified portfolio. The range of outcomes is huge - Tesla could conceivably become the [world's largest company](#), but it could also go bust. Benjamin Graham once said so elegantly that “In the short run, the market is a voting machine but in the long run it is a weighing machine”. Right now, the voting is going only one way and the momentum is strong but taking a longer-term view is much harder. Frankly we would need a time travel machine to comment with any confidence, which ironically just might be one of Elon Musk's secret projects.

INDEX RETURNS

Index	Region/Asset Class	31 May 2017	1m Change	1 Yr Change	2 Yr Change
UK 100	UK	7,520.0	+4.4%	+20.7%	+7.7%
UK Mid Cap	UK	569.6	+2.1%	+13.9%	+6.5%
UK Small Cap	UK	5,655.2	+2.3%	+23.0%	+18.1%
Dow Jones Ind Avg	USA	21,008.7	+0.3%	+18.1%	+16.6%
S&P 500 Index	USA	2,411.8	+1.2%	+15.0%	+14.4%
NASDAQ Comp.	USA	6,198.5	+2.5%	+25.3%	+22.3%
Nikkei 225	Japan	19,650.6	+2.4%	+14.0%	-4.4%
Euro Stoxx 50	Europe	3,554.6	-0.1%	+16.0%	-0.5%
CAC 40 Index	France	5,283.6	+0.3%	+17.3%	+5.5%
DAX Index	Germany	12,615.1	+1.4%	+22.9%	+10.5%
Milan Index	Italy	20,731.7	+0.6%	+15.0%	-11.8%
MSCI Emg Mkts (€)	Emg Mkts	515.4	+3.2%	+43.6%	+24.0%
IBOVESPA Index	Brazil	62,711.5	-4.1%	+29.4%	+18.9%
MICEX Index	Russia	1,900.4	-5.8%	+0.1%	+18.1%
S&P BSE SENSEX	India	31,145.8	+4.1%	+16.8%	+11.9%
Shanghai SE Comp.	China	3,117.2	-1.2%	+6.9%	-32.4%
Hang Seng	Hong Kong	25,660.7	+4.2%	+23.3%	-6.4%
UK All Property	UK Property	6,877.9	+0.3%	+3.7%	+9.4%
UK Conv Gilts	UK Gilts	3,606.6	+0.5%	+6.8%	+12.8%
UK Index linked Gilts	UK Gilts	4,922.1	-1.7%	+21.1%	+23.3%
JPM Glob Agg. Bond	Global Bonds	810.7	+1.7%	+13.7%	+25.5%
iBoxx Non-Gilt	UK Corp Bonds	338.0	+1.1%	+9.5%	+13.2%
WTI Crude \$	Oil	\$48.32	-2.0%	-1.6%	-19.9%
LMEX	Base Metals	2,759.2	-0.8%	+22.8%	+0.9%
Gold Spot \$/oz	Commodities	\$1,268.9	+0.1%	+4.4%	+6.6%
S&P Agri & Livestock	Agriculture	807.8	+0.3%	-8.4%	-11.8%
£1 = US\$	Currencies	\$1.29	-0.5%	-11.0%	-15.7%
£1 = €	Currencies	€ 1.15	-3.5%	-11.9%	-17.6%
£1 = Yen	Currencies	¥142.79	-1.1%	-10.9%	-24.8%

12M INDEX RETURNS

(INCLUDING DIVIDENDS, MEASURED IN £)



Source: Albert E Sharp, Bloomberg®

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