TESLA DEBT: ONE YEAR LATER

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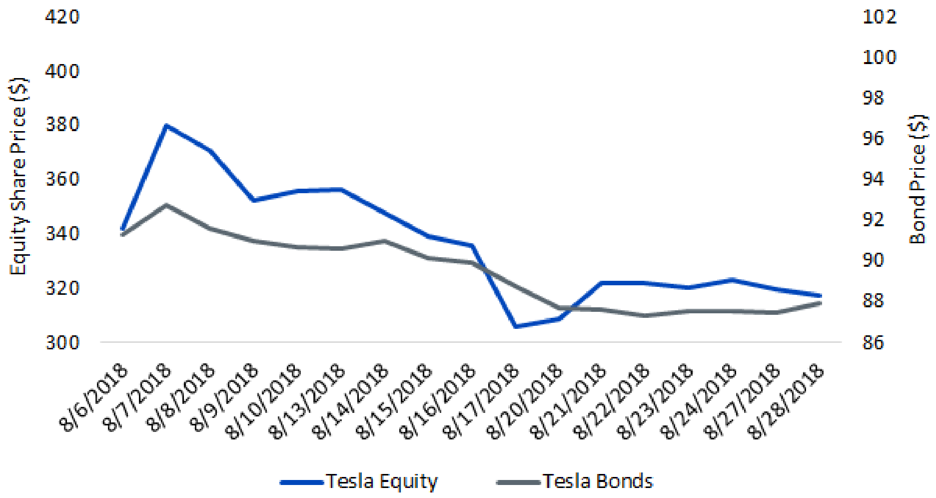
In what feels like an eternity, Tesla's [1] first salvo of fixed-term debt was issued just over one year ago on August 15, 2017. On August 7, 2018, Tesla CEO Elon Musk cryptically announced via Twitter that he is considering taking Tesla private at $420 per share. On August 24, 2018, Tesla announced in a blog post that the company would be remaining public. In an earlier post, we highlighted why we believe high-yield investors should avoid Tesla debt based on our view of company fundamentals. Our conclusion is based on the rate at which Tesla burns cash, resulting in significantly negative free cash flow. In a similar vein, New York University professor Aswath Damodaran, an expert on corporate valuation, has argued that companies like Tesla should never issue debt in the first place! While the stock initially ripped higher and then fell back below the pre-management buyout (MBO) pricing, trading in fixed coupon Tesla debt could only be described as muted. Below, we seek to draw some conclusions about recent action in the bond market and what it may mean for investors going forward.

Tesla Debt & Equity

While equity investors reacted to Musk's tweet by pushing the stock higher by close to 10%, Tesla's bonds barely budged. Curiously, this occurred despite a change of control provision that allows investors to sell their debt back to the company at $102.

In our view, we can rationalize the muted response in the bond market in two ways: the casualness of the announcement lacked credibility despite it coming from the CEO of a publicly traded company, and bond investors were more skeptical that a technical change of control would be triggered. On this second point, Musk subsequently "clarified" that existing shareholders need not tender their shares and could instead remain invested in the new private entity. If Musk would have been able to put together a transaction that restricts a new investor from acquiring more than a 50% stake, it's possible that existing covenants could have been avoided.

Reaction to Tesla MBO Announcement



Source: Bloomberg, as of 8/28/18. Past performance is not indicative of future results.

While untested, this ambiguity primarily seems to serve as an easy way to qualify his "funding secured" representation that the Securities and Exchange Commission is investigating. Regardless, observable market prices were skeptical given the minimal details of the plan. Before suspending their coverage, Goldman Sachs had assigned a six-month fair value price of $210 or a 50% discount to Musk's plan.[2]

Positioning Portfolios

While we remain on the sidelines as the Tesla story continues to evolve, we do believe that the performance of Tesla's debt can offer valuable clues as we progress later into the credit cycle. In this instance, we believe investors should assess the underlying fundamentals of the businesses to which they're lending.

As we show below, we believe we may be starting to see a marked divergence between lower-quality issuers and companies with stronger fundamentals such as strong free cash flow. Since the start of the year, the WisdomTree Fundamental U.S. High Yield Corporate Bond Index (WFCHY) has slowly started to pull away from its market capitalization weighted benchmark.[3] Compared with Tesla's bonds, both strategies have outperformed since Tesla issued last August.

Total Returns: WFCHY vs. High Yield vs. Tesla Debt

Source: Bloomberg, as of 8/27/18. Past performance is not indicative of future results. You cannot invest directly in an index.

Conclusion

While it's possible that Tesla can build on recent production momentum, we do not believe that Tesla's debt is currently worth the risk. For investors seeking high levels of income while still being mindful of fundamentals, we believe the WisdomTree Fundamental U.S. High Yield Corporate Bond Fund (WFHY) could strike a more appropriate balance between risk and reward.

[1]For holdings of Tesla in WFHY, please click here.

[2]Source: Goldman Sachs, as of 8/8/18.

[3]As represented by the ICE BofAML U.S. High Yield Master II Index (H0A0).

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DEFINITIONS

High Yield : Sometimes referred to as "junk bonds," these securities have a higher risk of default than investment-grade securitie.

Free Cash Flow : A measure of how much cash is left in the company after taking into account all the necessary expenses, including net capital expenditures.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Management buyout (MBO) : the process by which a corporate officer agrees to purchase a company from existing shareholders.

Change of control provision : a contractual agreement in a securities offering that provides investor protections should a company be acquired.

Covenants : Agreements within financial securities that specify certain obligations that need to be met at distinct points in time.

Market capitalization-weighting : Market cap = share prices x number of shares outstanding. Firms with the highest values receive the highest weights in approaches designed to weight firms by market cap.