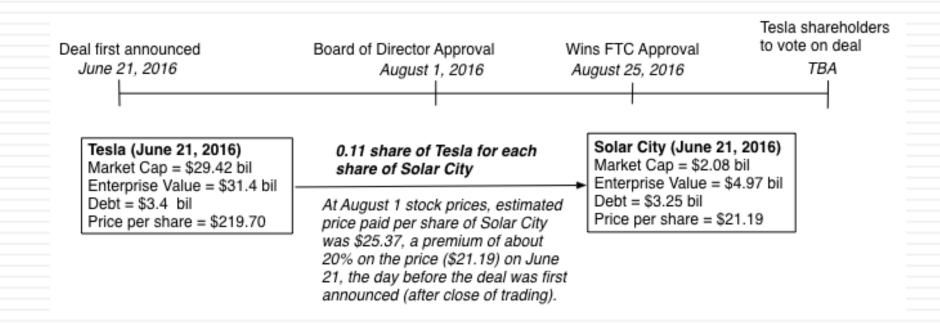
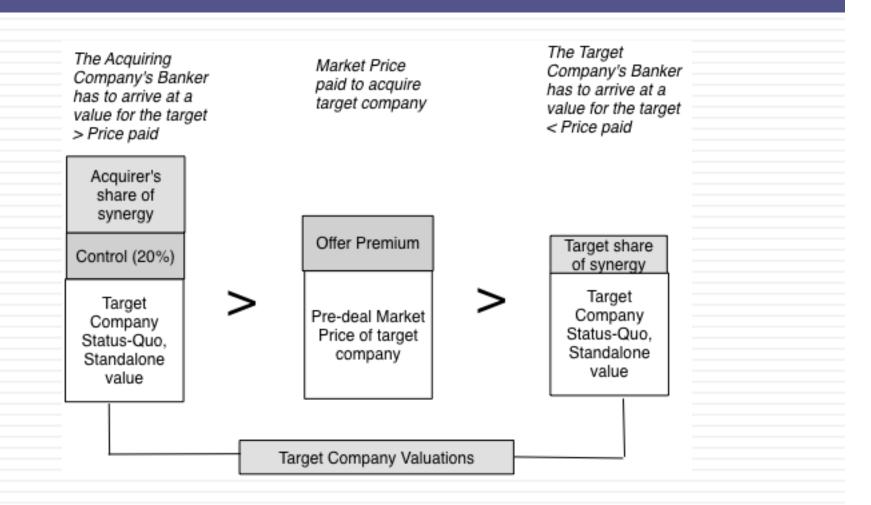
VALUATION KEYSTONE KOPS: LAZARD, EVERCORE & TSLA/SCTY

Bias, greed and ignorance!

The Tesla/Solar City Deal



The Banker's Dilemma in Friendly Deals



The Special Challenge in the TSLA/SCTY Deal

- Where is the synergy?
 - Though Musk claimed that the deal was a no-brainer, the logic of the deal and the potential for synergy looks like a far reach.
 - There may be some cost advantages, though it seems to be primarily in Solar City (and does not require a merger to accomplish)
 - The revenue gains are even more remote.
- Where is the control value?
 - Though the companies are independent entities, they are both controlled by Elon Musk.
 - The essence of control is that you think that one of these companies is badly run (presumably Solar City).
 - If so, what's stopping Mr. Musk from changing the management of the company?

The Evidence

	Tesla Valuation/ Pricing		Solar City Valuation/ Pricing		Implied Exchange Ratio	
	Evercore	Lazard	Evercore	Lazard	Evercore	Lazard
Cash flows used	Instructed by Tesla Board to use 1. Goldman Sachs Equity Research (GSER) forecasts for 2016-2020 2. IBES consensus forecasts		Solar City supplied forecasts of cash flows with 1. Unrestricted access to capital markets (LIQ) 2. Restricted access to capital markets (NOLIQ)		"Fair" ratio is 0.124-0.699 Tesla shares/ Solar City share, making the actual offer of	Using midpoints for Tesla value and SCTY (NOLIQ) value, the fair ratio is 0.0819 Tesla
Discount Rate	10-12% (Cost of capital)	12-13% (Cost of capital)	12-15% (Cost of equity), on levered cash flows	9.5-10.5% (Cost of capital) on unlevered cash flows	0.11 Tesla shares a good deal for Tesla shareholders	shares/ Solar City share, making the actual offer of 0.11 Tesla shares a good deal for Solar City shareholders
Terminal Value	6-8% growth rate in perpetuity	10-18 times EBITDA	3-5% growth rate in perpetuity	1.5-3% growth rate in perpetuity		
Value per share	GSER: \$88.36- \$302.21 IBES: \$132.92- \$451.02	GSER: \$145- \$270 IBES: Not done/reported	LIQ: \$37.51- \$61.53 NOLIQ: \$24.76- \$42.72	LIQ: \$18.75- \$37.75 NOLIQ: \$10.75- \$23.25		
Compensation Received	Evercore: \$1.25 million as opinion fee + \$5.75 million contingent on deal happening Lazard: \$ 2 million + 0.4% of equity value of Solar City contingent on deal happening					

The Misdemeanors

- No internal checks for consistency: There is almost a cavalier disregard for the connection between growth, risk and reinvestment. Thus, when both banks use ranges of growth for their perpetual value estimates, it looks like neither adjusts the cash flows as growth rates change.
- <u>Discount Rates</u>: I will give both bankers the benefit of the doubt and attribute the differences in their costs of capital to estimation differences, rather than to bias. The bigger question, though, is why the discount rates don't change as you move through time to 2021, where both Tesla and Solar City are described as slower growth, money making companies.
- Pricing and Valuation: Both bankers move back and forth between value and price and often mix the two, with Lazard estimating the terminal value in its Tesla as ten times EBITDA.

The Felonies

- Outsourcing of cash flows: It looks like both bankers used cash flow forecasts provided to them by the management. In the case of Tesla, the expected cash flows for 2016-2020 were generated by Goldman Sachs Equity Research (GSER, See Page 99 of prospectus) and for Solar City, the cash flows for that same period were provided by Solar City, conveniently under two scenarios, one with a liquidity crunch and one without.
- Terminal Value Hijinks: While there are a multitude of estimation issues that plague perpetual growth based terminal value, from not adjusting the cost of capital to reflect mature company status to not modifying the reinvestment to reflect stable growth, there is one mistake that is deadly, and that is assuming a growth rate that is higher than that of the economy forever.

The Verdict

- Lazard is <u>guilty of laziness</u>, plugging in discount rates into someone else's cash flow forecasts and getting paid \$2 million plus for that service.
- Evercore's valuations are horror stories, with bad assumptions piled on top of impossible assumptions. Guilty of both laziness and incompetence.
- Goldman is the mystery here. While the bank is mentioned only in passing, it was Tesla's investment bank until earlier this year. While they will claim that they have nothing to do with this deal. <u>Verdict delayed</u>, <u>pending answers to three questions</u>:
 - a) Did Goldman had any input into the choice of deal bankers?
 - b) Did Goldman have any role in the estimation of Solar City cash flows?
 - How did the Goldman Sachs Equity Research forecast became the basis for the Tesla valuations

The Sentencing

- Legal Sanctions: Not likely. The courts have tended to give too much respect for precedence and expert witnesses, even when the precedent or expert testimony fails common sense tests and it is possible that these valuations, while abysmal, will pass the legally defensible test.
- Loss of Business: For the many companies that do bad deals and need an investment banking sign-off on that deal (in the form of a fairness opinion), ineptitude in banking may be a plus, not a minus.