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BUSINESS DAY

Tesla Has Something Hotter Than Cars to Sell: Its Story

Common Sense

By JAMES B. STEWART APRIL 6, 2017

As Tesla shares surged past $300 this week and the company's market value surpassed Ford's, even its founder, Elon Musk, acknowledged on Twitter that the company was "absurdly overvalued if based on the past."

By "the past," he presumably means old-fashioned valuation measures like price-to-earnings or price-to-sales ratios, the traditional benchmarks for evaluating stock prices. By those measures, Tesla — a company that lost $773 million last year — is indeed off the charts.

Tesla's market value of nearly $49 billion is not only higher than that of Ford, which earned nearly $11 billion in profit last year, but is within easy striking distance of General Motors, which earned $9.4 billion.

In contrast to Tesla, Ford and G.M. shares have dropped recently on fears that auto sales have hit a cyclical peak. Ford and G.M. executives wouldn't comment on Tesla's stock surge, but it's easy to imagine they'd be tearing their hair out in frustration.

"It's nuts," Bruce Greenwald, a professor at Columbia Business School and an expert in value investing, said of Tesla's stock price. "Investors believe it's going to dominate a market that no company has ever dominated before."

But Tesla is not a stock, or a company, that is measured by the past, as Mr. Musk is well aware. He also wrote on Twitter that stock prices represent "riskadjusted future cash flows" — and Tesla is about nothing if not a utopian future of safe, reliable, powerful, self-driving electric vehicles powered by solar-fed batteries that are easy on the environment.

In that regard, Tesla has ascended into a rarefied realm of so-called story stocks — companies that have so bewitched investors that their stock prices are impervious to any traditional valuation measures because their stories are simply too good not to be true.

And to the dismay of short-sellers, who believe they have ample rational reasons to bet against such stocks, their share prices can stay in the stratosphere for years, even decades.

These story stocks — the term was coined by James Montier, a value investor and a member of the asset allocation team at the investment management firm GMO — are relatively rare, but hardly new. Amazon's stock surged for decades even without any meaningful profits. A more recent example is Snapchat's parent, Snap, which is racking up large losses while its stock trades at an astronomical price-to-sales ratio of nearly 50, far higher than Tesla's 7. (Ford's, by comparison, is 0.3.)

Amazon and Snap both have stories that are compelling for many investors: Amazon has transformed retailing and is destined to dominate it. Snap is reinventing communication, at least for millennials and those even younger.

Early investors in Uber and Airbnb, though they remain private companies, have valued them at stratospheric multiples based largely on the notion that Uber will transform and dominate local transportation and Airbnb will revolutionize the hotel industry.

For story stocks, any development that lends credence to the story can cause a surge in already high valuations. This week Tesla reported quarterly sales that were modestly above expectations, and the stock surged 7 percent in a day. Tesla shares are up nearly 40 percent this year, even though many investors considered them overvalued in January.

Ron Baron, the billionaire investor and founder of Baron Capital, disclosed last year that he owned about 1.6 million Tesla shares. He predicted on CNBC in February that Tesla shares would quadruple by 2020 and triple again by 2025. By then he expects Tesla to become the largest company in the world as measured by market capitalization.

For all the excitement and promise surrounding such companies, there are many cautionary tales.

“Stories are great before bed, but are disastrous as a stock-selection technique,” Mr. Montier wrote in his 2009 book “Value Investing: Tools and Techniques for Intelligent Investment.” If something is expensive based on traditional valuation metrics, he said, “you had better believe its story, as that is all you have.”

(A Tesla spokeswoman said Mr. Musk could not be reached for comment.)

Various studies have shown that stocks with high price-to-sales ratios, on average, significantly underperform market averages. For every Tesla or Uber, there’s a Valeant Pharmaceuticals or Theranos — two story stocks that seduced an astounding array of prominent investors and supporters based on stories that did turn out to be too good to be true.

And while many investors’ memories tend to be short, the so-called dot-com bubble in the late 1990s spawned scores of story stocks, nearly all of them now worthless and forgotten.

Still, Mr. Montier acknowledged, “Stories are compelling.” They appeal to intuition rather than reason. “But perhaps investors would be well advised to follow Odysseus’s example of putting beeswax in his crew’s ears and tying himself to the mast in order to avoid the disastrous, but oh so desirable, call of the Siren song.”

Will Tesla be one of the rare exceptions and, as Mr. Baron has predicted, emerge as the world’s most valuable company?

The company has won over many skeptics with its near-flawless execution, so far, and the high quality of its vehicles and high levels of consumer satisfaction. It is no longer a start-up: It delivered 25,000 vehicles in the last quarter. It is on track to achieve economies of scale, and the company says the gross margin on each vehicle is above 20 percent, far higher than the industry average. That could drive enormous future profits.

But that's not the Tesla story — or stories — investors are betting on.

Adam Jonas, a Morgan Stanley automotive analyst who is hardly a starry-eyed optimist about the industry, upgraded Tesla shares to overweight in January. He singles out the company's new autonomous driving technology as a compelling safety feature that will significantly reduce occupant and pedestrian injuries and fatalities. This week he said he expected "vehicle safety to be the primary differentiator in Tesla's upcoming product offensive," referring to the eagerly anticipated introduction of Tesla's new, lower-price Model 3, which will be equipped with the new technology.

That Tesla is an all-electric, environmentally friendly, nonfossil-fuel vehicle — the story that once excited investors — is barely mentioned anymore.

Even more futuristic is the idea that Tesla cars will be entirely self-driving, able to cruise streets nearly full time (except when they are being charged at Tesla's high-speed battery-charging stations). In this vision, Tesla owners will share their vehicles with Tesla when not using them, and during that time they will ferry other passengers, serving as Tesla's version of Uber. Thus Tesla will disrupt Uber's nascent market dominance.

And Tesla is no longer seen just as a vehicle manufacturer. With its solar and battery technologies, it is in a position to dominate two other enormous industry segments. Tesla "is reinventing the electric grid," as Mr. Baron said on CNBC. "That's a bigger opportunity than cars."

Even if all that comes to pass, it may not be enough to justify Tesla's valuation unless it can sustain a competitive advantage over time, as Mr. Greenwald, the value investing expert, put it. Tesla is spending heavily on research and development, and perhaps its technology will be difficult or impossible for others to replicate. The established automakers have had years to catch up to or overtake Tesla's Model S, with a conspicuous lack of success.

But for committed value investors, the writing is on the wall: "Is Tesla going to dominate its industry? That's the key question," Mr. Greenwald said. "When it comes to the global auto industry, no one ever has, and in all likelihood, no one ever will."

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