

Q1 2014 Earnings Call

Company Participants

- Deepak Ahuja
- Elon R. Musk
- Jeffrey B. Straubel
- Jeffrey K. Evanson

Other Participants

- Adam Jonas, Morgan Stanley & Co. LLC
- Andrea Susan James, Dougherty & Co. LLC
- Ben J. Kallo, Robert W. Baird & Co. (Broker)
- Brian A. Johnson, Barclays Capital, Inc.
- Colin W. Rusch, Northland Securities, Inc.
- Craig E. Irwin, Wedbush Securities, Inc.
- John D. Lovallo, Bank of America Merrill Lynch
- Patrick K. Archambault, Goldman Sachs & Co.
- Rahul X. Chadha, UBS Securities LLC
- Rod A. Lache, Deutsche Bank Securities, Inc.

MANAGEMENT DISCUSSION SECTION

Operator

Good day, ladies and gentlemen, and welcome to the Tesla Motors first quarter 2014 financial results Q&A call. At this time, all participants are in a listen-only mode. Later, we will conduct a question and answer session; instructions will follow at that time.

I would now like to turn the call over to your host, Jeff Evanson with Investor Relations. Please go ahead.

Jeffrey K. Evanson {BIO 1535168 <GO>}

Thank you, Patrick, and good afternoon, everyone. Welcome to Tesla's first quarter financial results question and answer webcast. I'm joined today by Elon Musk, Tesla's Chairman and CEO, and Deepak Ahuja, Tesla's Chief Financial Officer, as well as JB Straubel, our Chief Technology Officer.

We announced first quarter results today in our quarterly Shareholder Letter. This letter is available at the same link as this webcast. Also, a replay of this webcast will

be available later today at the same link.

Please note that certain financial measures used on this call, such as revenue and income, are expressed on a non-GAAP basis and have been adjusted to exclude the effect of lease accounting used on Model S sales, with the residual value guarantee, and charges related to stock-based compensation. Our GAAP results and reconciliations to non-GAAP measures can be found in the Shareholder Letter.

During the course of this call, we may discuss our business outlook and make other forward-looking statements. Such statements are predictions based on management's expectations as of today. Actual events or results could differ materially due to a number of risks and uncertainties, including those mentioned in our most recent Form 10-K filed with the SEC.

So we are ready to take questions. So please press *1 to ask a question. We are going to try to limit the call to about 45 minutes. So please be respectful of other callers by limiting your questions.

So, Patrick, let's have the first question please.

Q&A

Operator

Our first question comes from Brian Johnson with Barclays. Your line is open.

Q - Brian A. Johnson {BIO 21263539 <GO>}

Yes, good afternoon. I know, Elon, you're back from China. Just wanted to get a sense of what the order book in China is looking for? How much of a contribution that's going to make to your especially second half implied delivery targets? And then, do you have to get beyond Beijing or Shanghai this year in order to grow further in China?

A - Elon R. Musk {BIO 1954518 <GO>}

Well, I really don't think we've got any kind of demand challenge in China. In fact, I was blown away by my visit to China at the level of interest and enthusiasm for Tesla and the amount of goodwill that I encountered from people at all levels, from the government, from people in industry, and consumers in general. And I'm really optimistic for how things will go there.

We are trying to expand our service centers and Supercharger coverage as fast as possible in China. It's not to generate sales. It's just in order to be able to deal with the cars that we deliver in market. So we're really doing very few stores in China. Our focus is 90% plus on service centers and Superchargers. And then I think we'll actually have to limit the amount of cars we send to China, otherwise it would starve the rest-of-world production. So, I mean, that's really how we view things there.

I did mention that we elected to do local vehicle production in China in three or four years, although I should mention that goodwill existed before I said that. Goodwill wasn't a as function of that. But that will be for vehicles delivered to the local market in China and perhaps to some surrounding countries. And actually, just to be clearer, that wouldn't mean shifting any production from California. That would be assuming that California is starting to reach its max production. It makes sense for us to start looking at local country factories. And we would be looking at one in Europe as well. These are really aimed at minimizing logistics costs, because shipping two tons of metal over long distances is not very efficient. So it's just a sensible thing to do is to try to satisfy local demand with local production over time.

Q - Brian A. Johnson {BIO 21263539 <GO>}

And any sense of quantification, either the orders or the deposits or the wait times in China?

A - Elon R. Musk {BIO 1954518 <GO>}

We're actually really trying to get the wait times down in China. It's really quite a long wait time. In fact, the only source of unhappiness that I encountered in China was that some customers who are in some of the mid-sized cities are unhappy that we're delaying their deliveries, because it'll take us a bit longer to get the service and Supercharger access, but service is a necessary requirement. We can't have a service center be like 500 miles away from where somebody lives. So our biggest issue in China is, like, customer unhappiness that they're not getting their cars soon enough. And I think the wait time is quite long. In some cases it's like four months or five months or something like that.

Q - Brian A. Johnson {BIO 21263539 <GO>}

Thanks.

A - Elon R. Musk {BIO 1954518 <GO>}

Okay.

A - Jeffrey K. Evanson {BIO 1535168 <GO>}

Thanks, Brian.

Operator

Our next question comes from Andrea James with Dougherty & Company. Your line is open.

Q - Andrea Susan James {BIO 20758120 <GO>}

Thanks for taking my questions. Your R&D expense is ramping pretty significantly sequentially in Q2, and I was wondering if you could just talk about what components make up the R&D increase? And then also in line with that, how are the costs to bring the Model X to market kind of tracking against your earlier expectations?

A - Deepak Ahuja {BIO 15935173 <GO>}

Hi, AJ. So our R&D expenses went up exactly as planned in Q1, and it's primarily driven by all the engineering design and testing work that's going on, on our new product development. It's the Model X, as well as what we're doing to get the Model S ready for China and other markets.

A - Elon R. Musk {BIO 1954518 <GO>}

Yeah, for example, like right-hand drive is -

A - Deepak Ahuja {BIO 15935173 <GO>}

Exactly.

A - Elon R. Musk {BIO 1954518 <GO>}

Japan localization, China localization, UK.

A - Deepak Ahuja {BIO 15935173 <GO>}

Right.

A - Elon R. Musk {BIO 1954518 <GO>}

Hong Kong, that kind of thing.

A - Deepak Ahuja {BIO 15935173 <GO>}

Right, so it's more driven by those expenses rather than just head count increases, and so these are the cyclical expenses that you typically see before the launch of new products.

A - Elon R. Musk {BIO 1954518 <GO>}

Yeah, I should say that some of that is also that we want to do ongoing improvement to the Model S. As time's gone by, we've made hundreds of small improvements to the car. And lot of these people wouldn't necessarily notice, but I think collectively they add up to an improved experience with the car. So we've made some improvements in seat comfort, for example. And here and there in fit and finish. We're modifying the rear door so it can open wider, so rear ingress and egress has improved. There's a whole bunch much things -

A - Deepak Ahuja {BIO 15935173 <GO>}

Software improvements that we continue to make -

A - Elon R. Musk {BIO 1954518 <GO>}

We continue to make software improvements. I think there's some - it's very exciting, software updates that are going to come out in the next few months that will improve the experience for the whole fleet of customers out there. And if anyone's thinking

about asking me about that, I'm not going to say what they are, so just - it's a lot of information as it is. But I think customers can certainly look forward to some really awesome functionality improvements in their existing car.

A - Deepak Ahuja {BIO 15935173 <GO>}

We're doing lot more in-country testing before launching in new markets to make sure it's an outstanding customer experience. We did that in China and doing in other countries too.

A - Elon R. Musk {BIO 1954518 <GO>}

Yeah. Exactly. I was mentioning earlier, there was a bit of unhappiness in China about some of the midsized cities, delaying customers' deliveries. But what we found is that it's more important that we can service the cars really well, the charging is sorted out, and to make sure that when customers do get their car, they have an excellent experience. And I think we didn't do as good a job as we should have done in some of our prior market launches. We want to make sure we recognize that mistake and correct it going forward.

A - Deepak Ahuja {BIO 15935173 <GO>}

And I want to make sure I mention Model X costs are also obviously driving the increased R&D expenses as we're working through Model X.

A - Elon R. Musk {BIO 1954518 <GO>}

Model X is like the biggest driver of R&D expense, honestly. With the X, we're really trying to make an amazing car and, very importantly, to have a car that - where the production version is better than the prototype, better than the show car. The one thing that drives me crazy about the car industry is like you'll often these great show cars. And then when you actually get the production car, it's some bizarre, dumbed-down facsimile of the exciting prototype that was displayed. That's terrible.

The baseline expectation says that whenever we have a prototype, the production car is better in every way. So that's quite difficult to do and requires some greater problem solving. With Model X, the one biggest challenge is the falcon-wing door, making sure that is truly a step-change and utility for the car, and not a gimmick. So it's got to work perfectly, and the details have to be just right, and it's amazing how like seating and little things become quite significant engineering challenges, such as for example, getting the seals on the falcon-wing door to work properly and not be too prominent. So that you've got a seal, obviously, against rain, wind, snow and against road noise, but you've got to - something that's articulating across multiple hinges, you've got key junction joints and that kind of thing. So it's quite a difficult sealing problem to get it right and be consistent and remain good over many years. So we spent a lot of time on seal engineering.

Q - Andrea Susan James {BIO 20758120 <GO>}

Thank you for the thorough response. And one more and then I'm done. Why haven't your Gigafactory partner or partners, why haven't they signed on the dotted

line yet?

A - Elon R. Musk {BIO 1954518 <GO>}

I was actually – I was waiting for somebody to ask that question. So we actually do have a letter of intent signed with Panasonic. So we're happy to announce that we have a letter of intent signed. I mean, for us that's actually not that big of a deal because our expectation has always been that Panasonic would be the partner with the Gigafactory. I believe that's been Panasonic's intent. And in fact just to make sure we're both on the same page, JB spoke with Panasonic yesterday just to make sure we're on exactly the same page. So, JB, do you want to just elaborate on that?

A - Jeffrey B. Straubel {BIO 16619298 <GO>}

Sure. Well, as Elon said, we do have a signed letter of intent, and under that letter of intent, we've also created a joint working team between Panasonic and Tesla that's working almost daily, certainly weekly, exploring all the mutual topics and answering questions and making progress. We're actually quite comfortable that we're heading toward final agreements in the later part of this year, and it's something where, as we said, it doesn't seem like a big step change. It's something that's been progressing smoothly for the last months, and we feel confident in it.

A - Elon R. Musk {BIO 1954518 <GO>}

Yeah. I think we're quite confident, highly confident at this point of achieving the 30% reduction in costs per kilowatt hour, maybe moving towards – I'll say cautiously optimistic about exceeding that number. Now, I don't want to make any commitments, but I think we've got a decent chance of exceeding that number.

As we explore the cost structure on the supply chain, we're kind of talking with a number of other companies that make the precursor materials. We've found that there's really a lot of opportunity for innovation and overall cost reduction. And, in fact, we've had a number of conversations that are really interesting with mining companies talking about some of the key constituents that go into the cell, such as nickel and the cobalt, the lithium, although lithium is sometimes thought of as a bigger thing than it really is for lithium ion cells, it's like using maybe a couple percent of the cell mass.

But the biggest cost constituent is nickel. And so we're in conversations with some of the big nickel mines in Canada in particular. And we've been really I'd say positively surprised by the potential for cost reduction on producing the precursor materials. And it's kind of funny. It's like the – in talking to like of mining companies, it's like nobody ever calls them. We call them up and, like, hey we never get calls from companies like Tesla. (15:46) metal exchange or for the big stainless steel companies, because nickel is a common alloy and constituent in steel, and like cutlery, for example, usually involves quite a bit of nickel. So your knife and fork is usually electroplated nickel silver is usually what they do.

So the mining guys were like super-happy to hear from us and have quite good ideas for how to optimize the cost of materials, for minimizing logistics and

processing and just doing a fairly sensible things, lot of it's actually quite obvious, to create a supply chain that can deliver a large volume of battery packs with dramatically reduced costs.

And I should say we're also trying to do our best to ensure that in the supply of the components for the cell that our suppliers, going all the way to the mine level, are companies that operate in a good and fair way. Like, do they take reasonable care from an environmental standpoint, do they take care of the people working in the mine? That kind of thing. So as much as we can, we want to make sure that our suppliers are good suppliers.

Q - Andrea Susan James {BIO 20758120 <GO>}

Fantastic. Thank you so much.

Operator

Our next question comes from Adam Jonas from Morgan Stanley. Your line is open.

Q - Adam Jonas {BIO 3339456 <GO>}

First question is to follow up on the Gigafactory. Is the formal announcement, or kind of more than a letter of intent, a prerequisite for breaking ground on the factory?

A - Elon R. Musk {BIO 1954518 <GO>}

No, we actually expect to break ground on the first Gigafactory location - actually I don't want to be precise about this because I don't want any of the states with which we're talking to sort of have the wrong impression. We're going to move forward with breaking ground on multiple sites in order to minimize the risk of completion of Gigafactory, and we expect to break ground on the first of those probably next month, which is really quite soon. And then, shortly thereafter, maybe a month or two after that, we'll break ground on the second one.

And I should also say that California is potentially back in the running, but it's still in these sort of improbable - but it is back in the running, and the Governor and his staff have really, I think, tried to do everything they can to make California a significant candidate for the Gigafactory. The main thing with California is, it's got nothing to do with incentives or anything like that; it's the time to completion of the Gigafactory. I don't think we did a good job explaining why California wasn't on the list of four states to begin with, and it's just because this is a large greenfield construction project. California has quite a complex and lengthy process for approval of greenfield sites.

And so what we couldn't afford was waiting like a year or more for permits to proceed, which would (19:56) no environmental impact of any significance. But it would just take a long time for California regulatory agencies to process the information that they would need to fulfill their obligations under California law. Whereas in other states it's a much more streamlined approach. And the vehicles that we built in Fremont in California, if we don't have the Gigafactory online when

we have the vehicle capacity online, we will actually be in deep trouble, because we'll have all the equipment and tooling and people for making cars but not be able to produce the battery packs. And so that was the reason why California wasn't originally on the list.

Q - Adam Jonas {BIO 3339456 <GO>}

Okay.

A - Elon R. Musk {BIO 1954518 <GO>}

The Governor and Legislature are going to try to do something about that, but I think the question of timing is still a big one, and they will also need to make sure that the ongoing operational costs of the Gigafactory are not significantly worse than other states. So I think, like I said, I think California is still in the improbable but not impossible category at this point.

Q - Adam Jonas {BIO 3339456 <GO>}

Okay. Thanks. Thanks, Elon. And if I can just add a follow-up, when you're thinking about the Gigafactory, is the idea to have just one dedicated full cell supplier like a Panasonic, or is it possible that it could be Panasonic and kind of some "coopetition" with another battery component or cell supplier making another part of the sub-cell, cathode or anode, or is it kind of mutual or pure exclusivity for Panasonic, for example?

And then finally on China, do you have - or the expansion of other manufacturing in China or Europe - is that within the scope of your current capitalization and financial resources, or is that something - or that of your expectation of your cash flow generation - or is that another item on the list that might require new capital at some point? Thank you.

A - Elon R. Musk {BIO 1954518 <GO>}

Yeah. So the way the Gigafactory is set up right now is we - Panasonic would be the only company producing cells in the Gigafactory. One way to think of Gigafactory is, sort of like an industrial park under one roof. Tesla's producing the modules. Tesla is sort of the overall I guess landlord. We're producing the modules and the battery pack, then the cells would be produced by Panasonic, and then we'd actually have a number of other companies producing a few precursors to the anode, cathode, separator, electrolyte, and so forth that are then feeding into Panasonic.

However, going back to our original short presentation on the Gigafactory, you'll see that the cell capacity target is around 35 gigawatt hours, but the pack capacity is 50. So we expect to bring in cells from other cell factories in the world to make up (23:10) roughly 15 gigawatt hours. And those would be - I would expect a lot of those would be Panasonic cells. But to the degree that Panasonic isn't able to meet that demand, there would be other suppliers as well.

Q - Adam Jonas {BIO 3339456 <GO>}

Okay.

Operator

Thank you. Our next question comes from Patrick Archambault with Goldman Sachs. Your line is open.

Q - Patrick K. Archambault {BIO 4638109 <GO>}

Good evening. Just a couple ones here. Just in terms of the cadence of some of the OpEx items, I mean, maybe just like R&D specifically, Deepak, you described how there's a sequential increase of 30%. I guess the first part of my question is how do we think about it trending in the back half? And then, sort of longer term, how do we see that as an expense as we sort of model out over the next couple years? I think best-in-class vehicle producers probably have that in the mid-single digits as a percentage of sales, but just given your growth profile, it would probably be higher. Can you help us just to dimension that just as we think about our forward modeling?

A - Deepak Ahuja {BIO 15935173 <GO>}

Yeah. In future quarters, as we go towards the end of the year and potentially next year early, as Model X development is behind us, I would expect some reduction in R&D spending. And then, of course, Gen III will pick up and other products that we still have working. But to your broader point of percentage of revenue, we clearly see that as revenue is going to pick up significantly. The percentage of revenue of R&D expenses is going to be, I expect, in the single digits, high single digits, clearly. So I think we won't be too far away in that sense from some of the other I would say more growth-oriented companies - don't want to just put it against automotive - because we will be doing more R&D in general.

A - Elon R. Musk {BIO 1954518 <GO>}

Absolutely.

Q - Patrick K. Archambault {BIO 4638109 <GO>}

Okay, great.

A - Elon R. Musk {BIO 1954518 <GO>}

I think our R&D is maybe more limited by the pace at which we can recruit great engineering talent and integrate it to the company rather than a budget.

A - Deepak Ahuja {BIO 15935173 <GO>}

Yes.

Q - Patrick K. Archambault {BIO 4638109 <GO>}

Got you. Okay. That's helpful. And then just as we think about the cadence of deliveries, which is obviously very back-half loaded, but you're obviously confident

in the 35,000. Can we just get a little bit more clarity as to what's driving sort of the back-half inflection? Is it cell capacity? Is it that second production line coming on? It seems like it's more supply driven than demand driven, but just wanted to get a little bit more clarity on what's driving that sequential progression?

A - Elon R. Musk {BIO 1954518 <GO>}

Yeah. The main thing in the first half of the year – and this is something actually I mentioned I think late last year – is that for the first half of this year we're constrained by cell supply. I mean, it is in the process of alleviating, and we expect that to really start alleviating in the third quarter basically. And there's obviously a bit of a delay because the cells are coming from Japan, so they've got to be produced and put on the water and brought over here and that kind of thing.

But thus far, from what we see, things are on track to be able to at least meet but probably exceed by a little bit the 35,000 targeted deliveries. Our production number obviously will be higher than that, because the company is growing quite a bit. And we've got a lot of vehicles that will be en route to various countries. And then there is that other constrainer we mentioned, which is the vehicle production line. So we'll actually be taking the Fremont factory down for roughly 10 days or so in July to convert to the new line, which enables a substantial increase in our production capacity on the vehicle side, as well as a labor-hours reduction. So, it's fundamentally more efficient process.

So it is worth highlighting the point, because very often in the media it seems like there's confusion between Tesla production and Tesla demand. For example, we're sold out of Q2 production already. But the term sales usually means demand, but in our case, sales means deliveries. It's not a measure of demand; it's a measure of how many cars we were actually able to get to customers. If we'd been better at production and delivery, we'd have delivered more cars.

A - Deepak Ahuja {BIO 15935173 <GO>}

Thank you.

Q - Patrick K. Archambault {BIO 4638109 <GO>}

Okay, thanks. Thank you, guys.

Operator

Our next question comes from Colin Rusch with Northland Capital Markets. Your line is open.

Q - Colin W. Rusch {BIO 15823117 <GO>}

With the Model X, previously you talked about going into production before the end of 2014. Can I just understand exactly what you're seeing with the prototypes being done by the end of the year versus production, and how we should think about that relative to the previous comments?

A - Elon R. Musk {BIO 1954518 <GO>}

Yeah, I mean, there's no question we're delayed on the Model X, although that's I wouldn't say particularly new information. So relative to our earlier forecast, we had to spend a lot more time making sure we got the Model S right, and it took longer to get to some of the international markets and whatnot. So it just didn't make sense for us to be focusing on Model X, if we didn't have our Model S house in order.

I think we're in a pretty good shape on the S front, so our focus is very heavily on the X and - as to making sure it's a phenomenal product, and we expect to be delivering production cars in roughly Q2 next year. We'll have the production design articles, like, I guess beta articles or production-release candidates around the end of this year, but we want to make sure we've got a decent period of validation with those release candidate vehicles, because the production ramp for Model X will be much greater than for S. So much deeper.

So with S we had quite a shallow production ramp; started off real slow and as we encountered issues, we were able to correct them without having a large number of cars from production on the roads. With X it's going to be sharp ramp, which means we really need to make sure that we've properly validated issues and all temperatures and climates and road types, that the car is really solid before ramping up production, otherwise we risk having a recall or a bad customer experience.

Q - Colin W. Rusch {BIO 15823117 <GO>}

Okay. And then just one quick technical question. As you look at the components in the materials inside of your cells, the quality of lithium. How much leverage do you think you can get as you start to see higher quality of lithium from the supply chain?

A - Elon R. Musk {BIO 1954518 <GO>}

The quality of lithium, I'm not sure what you mean by -

Q - Colin W. Rusch {BIO 15823117 <GO>}

In terms of higher purity, I should say.

A - Jeffrey B. Straubel {BIO 16619298 <GO>}

That's really not been an issue. Yeah. That's not a big trade-off or driver of performance. Really it's something that we're constantly looking at with the different suppliers and trading off different processing mechanisms and different feedstocks, and that can affect the pricing, but the ultimate purity doesn't really drive performance of the final cell.

A - Elon R. Musk {BIO 1954518 <GO>}

Yeah. I mean there are some things that are sort of a tricky - or that matter, like, for example, like the anode, the structure of the carbon in the anode is important. I mean, we use a very high percentage of synthetic graphite, because that gets a sort of a more precise microstructure. So there's some potential trade-offs there as to

how much work can be (33:04) put into creating the synthetic graphite. And I think generally we want to probably aim for highly precise microstructure. So - which is a little trickier to do. You don't want to just have the kind of random microstructure of the stuff that came out of ground.

Q - Colin W. Rusch {BIO 15823117 <GO>}

Okay. Thanks a lot, guys.

Operator

Our next question comes from John Lovallo with Merrill Lynch. Your line is open.

Q - John D. Lovallo {BIO 16511598 <GO>}

Hey, guys. Thank you very much for taking my call. First question is, we've recently had conversations with several of your customers in China and Hong Kong who have placed firm orders, pretty high trim levels, and now are actually seeking refunds because what they've discovered is that the electric wiring at the residential level is so poor that charging equipment is not being permitted in their high-rise buildings. So I guess the question is, I mean, are these one-off exceptions or are you guys seeing a trend in this?

A - Elon R. Musk {BIO 1954518 <GO>}

No. We're not really seeing a lot of cancellations, at least I've heard. I think one of the things is we have required of customers who place their deposit is that before they take delivery of their car, we want to make sure that they have a wall connector installed. But usually like the wiring situation (34:26) what max amperage the outlet can be. So some places may be able to handle an 80-amp outlet, some maybe only 20 amps. But it's pretty unusual to see this. Something we are doing, though, in China and other parts of the world is we're putting Superchargers in cities, not just between cities. This is obviously in important places like Beijing, Shanghai, London, San Francisco, New York, where at times people may have a challenge with having a fixed parking space. So it's less about maybe the wiring thing, it's more like some of those people don't have a definitive parking space; they might have street parking or something. London is a particularly tricky one where there is - a lot of high end neighborhoods just have street parking.

A - Jeffrey B. Straubel {BIO 16619298 <GO>}

Yeah. If I might add, there's been a lot of questions about the supposed poor quality of the grid in China. But from what we've seen, installing hard wire and charging equipment and Superchargers, it's actually been somewhat the opposite and been quite a robust very new, actually - new equipment and new grid. So we have not seen very many problems.

A - Elon R. Musk {BIO 1954518 <GO>}

Yeah. No, exactly. In fact, it's exactly as JB said, it's - we've actually found, it's been a positive surprise for us in China, not a negative one.

Q - John D. Lovallo {BIO 16511598 <GO>}

Okay. And then for my second question, I think in the release, you mentioned that North American deliveries were up I think 10% sequentially. So this would still imply that they were lower for the first quarter and the second quarter of 2013 and about in line with the third quarter. Is that a fair characterization?

A - Elon R. Musk {BIO 1954518 <GO>}

Do you want to just -

A - Deepak Ahuja {BIO 15935173 <GO>}

Yeah, John. Just to clarify, we said the orders in North America were up 10%, not deliveries.

Q - John D. Lovallo {BIO 16511598 <GO>}

Okay. So how were the deliveries in the quarter in North America?

A - Deepak Ahuja {BIO 15935173 <GO>}

The deliveries were down. We were trying to reduce the lead time in Europe. We had a long lead time there, and we were shipping a lot of cars into Europe, so that we come to a more even lead time between North America and Europe.

A - Elon R. Musk {BIO 1954518 <GO>}

Yeah. I mean, I think this is getting back to what I was talking about earlier, that it's easy to confuse deliveries with demand. Deliveries and demand are not the same thing for Tesla. They are for other car companies, but not for Tesla.

Q - John D. Lovallo {BIO 16511598 <GO>}

Okay. Thanks very much, guys.

A - Elon R. Musk {BIO 1954518 <GO>}

To be clear, we're are seeing a steadily increasing demand in North America.

Q - John D. Lovallo {BIO 16511598 <GO>}

Okay. Thanks, guys.

Operator

Your next question comes from Rod Lache with Deutsche Bank. Your line is open.

Q - Rod A. Lache {BIO 1528384 <GO>}

Hey, everybody. It seems like you're making a lot of progress in terms of purchase material and efficiency, just looking at the numbers. And what I'm looking at is, it

looks like your products gross profit, you reported like \$190 million last quarter, but there was a gain in there, so maybe it was \$180 million in Q4. And then this quarter, you did \$180 million including a charge. So it seems like your gross profit didn't move, even though your revenue was down. I'm just hoping that you can maybe give us a little bit of an update on where your incremental margins stand today. Just given some of the progress that you've made - on a steady-state basis these incremental units, what kind of conversion for incremental volume you've achieved today on the gross profit line?

A - Deepak Ahuja {BIO 15935173 <GO>}

Rod, I'm not exactly clear what your question is, but I think to your broader point, there is gross margin improvement that's happening because of cost improvements that we continue to achieve. And this is the internal roadmap that we have on a variety of actions to achieve material cost reduction, some internally, some at our suppliers, some through design. And those actions will continue throughout the year, and that's why we feel comfortable that we will achieve 28% gross margin by Q4.

A - Elon R. Musk {BIO 1954518 <GO>}

Yeah. I think a couple of important points I'd made here which is, so first of all, overall we don't do any cost down if it makes the product worse. So that doesn't really gain us anything, which - it's quite tempting to do that sometimes, and that drives me crazy when companies in other - elsewhere in the car industry or in other industries reduce costs by reducing value. That's not a good thing. So our cost reductions are really aimed at figuring out how to get the molecules in the right shape in a smarter way as opposed to trying to sort of strip value out. In fact, in a number of cases we've actually added cost to the car because there is something that needed to be improved. The underbody shield is an example of that. And our gross margin in Q1 will be - we have a number of sort of charges that negatively affected gross margin, would have been a little bit higher if it hadn't been for things like for example the underbody shield activity. But I think we feel really comfortable of achieving the 28% gross margin by the end of the year on the Model S front.

Q - Rod A. Lache {BIO 1528384 <GO>}

Okay. Thanks. And you indicated again in your release \$650 million to \$850 million of CapEx this year. Can you give us some high-level thoughts on preliminarily what next year might look like as you're starting to ramp up the Gigafactory? And also I know that you made some reference to SG&A and R&D as a percentage of sales. But I guess for your stage of development, I'm not sure that that's really applicable. Can you give us an idea of how that might look on an absolute basis?

A - Deepak Ahuja {BIO 15935173 <GO>}

Rod, it's a bit too early for us to give clearer guidance or thoughts on 2015 CapEx, clearly 2015 at a high level will be dominated by spending on the Gigafactory as well as we start to prepare for Gen III. I think much of Model S and Model X spending will be behind us. There'll be some lagging Model X spending from a CapEx perspective just before launch from a tooling and an equipment perspective. So there'll be a

small change - or there will be a change in the categorization of spending. And then beyond that, clearly we will continue to expand rapidly globally with our store service centers and Superchargers. So that growth will continue, but I think we can provide you a bit more clarity on that, perhaps a couple of quarters from now.

Q - Rod A. Lache {BIO 1528384 <GO>}

Okay. And just last one on China. When you do actually expand to domestic production, do those requirements for 50-50 JV partners, do they apply to you, or are there any exceptions for new energy vehicles, or do you actually have any thoughts on that at this point?

A - Elon R. Musk {BIO 1954518 <GO>}

I think it's too early to make a prediction on that front. Yeah, so, I think we can't say for sure how things will look at that time. I can say that we're postponing any serious partnership discussions with the companies in China because we're still really at too early a stage. So we're not trying to sort of run this to ground because we've got sort of really basic priorities of getting service and supercharging all that in China and so, yeah, we just don't have any - anything to say on that front yet.

Q - Rod A. Lache {BIO 1528384 <GO>}

Okay. Great. Thank you.

Operator

The next question comes from Ben Kallo with Robert W. Baird. Your line is open.

Q - Ben J. Kallo {BIO 16897436 <GO>}

All right. Thanks for taking my question. Back to the battery factory, can you talk about the costs associated with running two sites in parallel, maybe three, and any optionality you have there? And then adding maybe two more on top of it. One is, how much work have you done as far as business development with stationary stores to get comfortable with that that angle there? And then as far as additional investors, should we wait to see them after Panasonic comes to the table? And I'll stop there. Thanks, guys.

A - Deepak Ahuja {BIO 15935173 <GO>}

Well, there is - I mean, your first question was fundamentally, are we spending too much money by working on two sites together, and I think as Elon has said a few times, for us it's really critical that we have the first Gigafactory ready on time to supply the sales for Gen III and that every one-month delay at that point is far more expensive for us than the incremental cost that we may incur upfront to kick off two sites at one time.

A - Elon R. Musk {BIO 1954518 <GO>}

Absolutely.

A - Jeffrey B. Straubel {BIO 16619298 <GO>}

Yeah, maybe I can speak to the stationary business development part of the question. We have done a huge amount of work there, and we've talked to most major utilities and energy service companies at this point. It's still early days in that effort, and I think maybe the thing to focus on is, our long-term optimism looking at the price versus cost of what we expect we could do, and the long-term demand for stationary energy storage is quite extraordinary when you look at the size of the grid and what needs to be done with renewable energy and buffering the variability of that. So I think that's really where we keep our focus is on the long-term economics that could be enabled once the Gigafactory is online.

A - Elon R. Musk {BIO 1954518 <GO>}

Yeah, exactly. I mean, right now we're not trying to build demand for stationary storage because we are cell constrained, so – kind of at the expense of vehicles. So what we're doing right now is more on the engineering side figuring out what would be a really cool stationary storage pack that could be produced at volume and that could be combined, so you could stack a whole bunch of them if you wanted. So I think particularly for like the home solution, I mean, the sort of thing we have in mind is something that looks a bit like the battery pack in the Model S. So something really flat just maybe takes, it's just sort of coming 5 inches off the wall, like wall mounted, a beautiful cover, integrated bidirectional inverter, and it's just plug-and-play. That's the sort of thing we have in mind for the stationary storage pack on the residential front, which could conceivably you could stack a bunch of them and have something that works commercially as well. But we'll probably want to talk about that in detail end of the year or early next year or something like that.

A - Jeffrey B. Straubel {BIO 16619298 <GO>}

Yeah. And I think the third part of your question was about other participants in the Gigafactory, and we are talking to various different people in parallel. I think it's important to understand that there's a lot of aspects of this that Panasonic simply doesn't do. So it's not necessarily a competition, but it's complementary, different pieces of the production operation. So those discussions are under way, but it's premature to talk about any specifics.

Q - Ben J. Kallo {BIO 16897436 <GO>}

Great. Thank you guys very much.

Operator

Next question comes from Craig Irwin with Wedbush Securities. Your line is open.

Q - Craig E. Irwin {BIO 6209023 <GO>}

Good evening. Thank you for taking my question. So, Elon, when you look at the Chinese market, everybody knows that this is the largest luxury automotive market in the world. But it's not a market that we have as much visibility as we might like. How do you quantify the total opportunity for sales for Tesla? And what have you seen

since you launched in China that surprised you or maybe that you didn't expect? And how is this shaping the plans for your store map over there and the obvious service centers and the other investments?

A - Elon R. Musk {BIO 1954518 <GO>}

I don't think - I think you probably know as much as I do about the demand for our cars in China. So it's not as though I've got some incredible crystal ball. As you mentioned, China is the biggest market for cars in the world, and actually the biggest market for premium sedans in the world. So, to the degree that our sales track that of other manufacturers presumably China would over time become the biggest market for Tesla. I mean, that's probably the best guess that anyone could make at this point. All I know in the short term is that we really don't have a demand issue in China, like we've got a lot of demand. And so our focus then obviously is just to make sure that that demand is serviced, and we're trying to roll out service centers and Superchargers as fast as we possibly can. And my instructions to the China team are to spend money as fast as they can spend it without wasting it, so I think that's what's happening.

Q - Craig E. Irwin {BIO 6209023 <GO>}

Yeah, makes sense.

A - Jeffrey K. Evanson {BIO 1535168 <GO>}

Thanks, Craig. Patrick, let's make this the last question, please.

Operator

Our last question comes from Colin Langan with UBS. Your line is open.

Q - Rahul X. Chadha {BIO 16417961 <GO>}

Hi. This is Rahul Chadha on behalf of Colin. Can you help us understand the difference in the variable cost structure for a Model S compared to a comparable luxury sedan like maybe a BMW 7 Series? And other than the battery, which are the key areas where you'll be able to cut costs as you go ahead and achieve scale?

A - Elon R. Musk {BIO 1954518 <GO>}

We don't really know what the gross margin is of individual product lines in other companies. So it's difficult for us to make an exact comparison there. So I just don't know how to answer that question exactly. As far as cost reduction, the cost of the whole vehicle is not just in the battery pack; the battery pack is one portion of the car, and it's maybe a quarter of the value of the car. It's not the overwhelming portion of the car. So cost reduction is really coming across the board.

Q - Rahul X. Chadha {BIO 16417961 <GO>}

Are there any specific components which you see bigger opportunity to cut cost and/or the process?

A - Elon R. Musk {BIO 1954518 <GO>}

The biggest single cost reduction within Q4 this year would be related to labor and overhead, which as I mentioned earlier in the call, we have a much more efficient production line that's going to come online in July, which has more automation, and it's just set up in a better way. And so it's - making the car with greater labor efficiency is the biggest single improvement. But there are really hundreds of improvements across the board. And what it really comes down to is when you make anywhere from like a \$5 to a \$100 improvement here or there and everywhere, soon it adds up to a significant number. I wish there was like one place where there was this one incredibly stupid super-expensive thing that if we fixed would suddenly make the car cheap. That is unfortunately not the case.

Q - Rahul X. Chadha {BIO 16417961 <GO>}

Thank you. And then, do you have any update on the dispute with the dealer body?

A - Elon R. Musk {BIO 1954518 <GO>}

I think there was something that happened just today. I mean this stuff tends to be reported in real time, so it's not like there's something that we know that is not public information, but I think if the appeal in Massachusetts from the dealers was denied today, so dealers - what's that?

A - Operator

(52:46)

A - Elon R. Musk {BIO 1954518 <GO>}

Hearing. Okay, the hearing.

A - Operator

(52:51)

A - Elon R. Musk {BIO 1954518 <GO>}

Sorry?

A - Operator

(52:51)

A - Elon R. Musk {BIO 1954518 <GO>}

Oh, we didn't. I thought we got something (52:54).

A - Operator

(52:56).

A - Elon R. Musk {BIO 1954518 <GO>}

That's all? Okay, fine. All right. So, no update on the dealer front.

Q - Rahul X. Chadha {BIO 16417961 <GO>}

Okay. Thank you.

A - Elon R. Musk {BIO 1954518 <GO>}

Thanks.

A - Jeffrey K. Evanson {BIO 1535168 <GO>}

All right. Patrick, I apologize I cut off Craig Irwin there. If he's back in the queue, we can take another question from him.

Operator

We have Craig Irwin in queue, Wedbush Securities. Your line is open.

A - Jeffrey K. Evanson {BIO 1535168 <GO>}

Go ahead, Craig. Sorry about that.

Q - Craig E. Irwin {BIO 6209023 <GO>}

Thanks, Jeff. No, not a problem. So really appreciated the comment in the shareholder letter about 10% sequential growth in orders in North America. We understand you're obviously capacity constrained and you've got great demand. But one of the points of controversy is the potential for declining shipments into North America. Can you maybe give us a commentary about your year-over-year order rates in North America, whether or not you expect to continue selling Model S vehicles at similar volumes once you've started to satisfy some of the European and Asian demand?

A - Elon R. Musk {BIO 1954518 <GO>}

We'd rather not make any additional predictions about deliveries. I mean, I see demand in North America, and I can tell you, simply what we see is we see a steadily increasing demand in North America. That's the information that we have. We don't have something that's more predictive than that.

Q - Craig E. Irwin {BIO 6209023 <GO>}

That's helpful. Thank you.

A - Elon R. Musk {BIO 1954518 <GO>}

Okay.

A - Jeffrey K. Evanson {BIO 1535168 <GO>}

All right. Thank you, Patrick, for getting Craig back on the line. I appreciate that. So this concludes our call. Thank you, everyone, for joining us this afternoon. We look forward to seeing many of you this month in New York. Next Monday, we'll be at the Deutsche Bank Clean Tech Conference, and on Tuesday, we'll be at the Wedbush Transformational Technologies Conference. And finally, at the end of May, we're presenting at the Friedman Billings Ramsey Energy Technology Summit. So we hope to see some of you at some of those conferences. Thank you, everyone. Have a great day. Bye-bye.

Operator

Ladies and gentlemen, thank you for participating in today's program. This concludes the program. You may all disconnect.

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