GRANT'S
INTEREST RATE OBSERVER®
Vol. 33, No. 19b Two Wall Street, New York, New York 10005 • www.grantspub.com OCTOBER 2, 2015

Predatory borrower

SolarCity Corp. (SCTY on the Nasdaq) is America's largest solar power provider. Beyond this uncontested statement of fact, bulls and bears agree to disagree. Fully 45% of the equity float is sold short. Of the 17 sell-side analysts on the case, 14 rate the shares a buy. The story, for Grant's, concerns the SolarCity debt. The ecologically virtuous issuer of "Solar Bonds" ought to be ashamed of itself.

SolarCity is a capital-intensive and cash-burning enterprise. It lays out funds to install solar panels on rooftops at $21,000 per setup; it expects to collect lease payments on those assets for 20 years, and perhaps for another 10, if the lessee chooses to renew. The company in whose chairman's seat reposes Elon Musk consumed $587.3 million in free-cash flow through the year ended June 30. Unrated by any of the three major agencies, SolarCity has $2.3 billion of debt, net of cash. The figure may double as analysts pencil in a free-cash flow deficit of $2.6 billion for 2016.

SolarCity is a narrative for the growth-focused non-accountant. Fans thrilled to the news that, in the second quarter, the company installed 189 megawatts worth of solar panels, up 86%. They cheered at mid-year when "net retained value," a company-conceived metric for the net present value of future cash flows deriving from leased solar panels, grew to $3.06 billion, a $1.3 billion year-over-year increase. You half expect an analyst to pitch the stock on the basis of the fast convergence between net retained value and the $4 billion market capitalization.

Bears see the same data; they just see them differently. Thus, observes colleague Evan Lorenz, "SolarCity may be rapidly growing, but it isn't clear that the company will ever be profitable. In the second quarter, SolarCity's EBITDA (earnings before interest, taxes, depreciation and amortization) was negative $94.4 million. EBITDA is perhaps the most commonly gamed non-GAAP metric and nearly every company reports a positive EBITDA number.

"Another point of bearish focus," Lorenz proceeds, "are the assumptions underlying the net retained value metric. For instance, that no consumers default on their leases, that SolarCity will pay no taxes (the company holds net operating losses worth $745.9 million), that there will be no customer churn in the first 20 years and that 90% of customers will re-up up for more 10 years after the happy experience of the first 20."

"Just for illustrative purposes," Tim Messina, co-founder and portfolio manager of Tekarra Capital, a hedge fund that has sold short SolarCity common, tells Lorenz, "The last assumption alone [the one concerning lease renewals] represents over $900 million of the $3.057 billion net retained value estimate." Messina homes in, as well, on the 6% discount rate that management uses to arrive at its present-value calculation. "Using just an 8% discount rate, would reduce the estimate of net retained value by around $800 million," he says.

Neither do the longs and shorts see eye-to-eye on the tax credits that have proven so necessary to SolarCity's commercial viability. How would a reduction in these federal emoluments in 2017 impact SolarCity's business? Will future solar tax incentives favor leasing or buying? We don't know and neither does Donald Trump.

The duelling stock-market antagonists can certainly take care of themselves. We have less confidence in the sales resistance of the mom and pop investors whom SolarCity is inviting to fund its yawning cash-flow deficit. "Solar Bonds," Mr. and Mrs. America?

You'll find them advertised on the website solarbonds.solarcity.com. Any U.S. citizen over the age of 18 can buy them in maturities ranging from three months to 15 years. The ads compare the yield of the 10-year issue—a full 5%—with the meager fare available in "high-yield" CDs (2.75%), A-rated 10-year municipal bonds (2.65%), 10-year Treasurys (2%), and "high-yield" savings accounts (1.05%).

For SolarCity, the comparisons are more than flattering. Bank deposits are FDIC-insured, and though Musk may work his magic with the Treasury, and though the company and the Treasury both show losses, there's no comparing SolarCity, creditwise, with the government of the United States. As for those A-rated munis, SolarCity is, as mentioned, unrated. Anyway, if the company ever did throw off earnings, that income (after the expiration of the NOLs) would be taxable. The interest income on most municipal securities is, of course, exempt from federal taxes. To any in the 35% tax rate, a 2.65% muni yield equates to a 4.08% taxable equivalent yield.

As of June 30, there were $201.6 million of Solar Bonds outstanding. Musk's Space Exploration Technologies Corporation, or SpaceX, owned $165 million's worth maturing in 2016. In other words, non-Musk controlled entities held only $36 million. After the close of the quarter, SolarCity announced the issuance of up to $230 million of new Solar paper.

Give the company this much. The fine print does warn you (the fine print that the people who most need warning will probably never read). Solar Bonds, the prospectus discloses, offer much less credit protection than typical corporate debt instruments. "Examples of these different terms… include, among others:

- "your inability to initiate bankruptcy proceedings against SolarCity;
- "the lack of certain 'customary' investor protective covenants in the indenture;
- "your inability to require us to repurchase the Solar Bonds upon a change of control of SolarCity;
- "lack of cross-default provisions in the indenture with respect to our other debt; and
- "the lack of an underwriter to conduct third party due diligence and other types of 'gatekeeper' actions typically taken by an underwriter in an underwritten public offering."

While 5% may seem like a juicy yield after seven years of ZIRP, sophisticated investors demand more from a certain kind of unrated concept company. Take the SolarCity senior unsecured convertible 1$^5/_8$ of Nov. 1, 2019, which convert at $83.53 vs. the current share price of $41.04. They trade at 76.61, a price to yield 8.52%.

Illiquidity constitutes another investor hazard. You can sell munis (well, most of them), and you can sell Treasurys. You can pay a penalty to exit a long-dated CD. Solar Bonds bought through solarbonds.solarcity.com are not now transferrable (the company tells Lorenz that it is thinking about making a secondary market in them). "The Solar Bonds in each of the Offered Series are not transferable, except as required by law (such as a court order)," says the 10-year Solar bond prospectus. "This means that, absent a legal requirement to effect a transfer of a holder's Solar Bonds in any of the Offered Series, such holder is prohibited from selling or otherwise transferring its Solar Bonds in any of the Offered Series prior to maturity . . . . You should plan to hold the Solar Bonds until their maturity date."

Confusingly, SolarCity sells Solar Bonds directly to investors on its website, and indirectly through Incapital LLC, which distributes the securities to retail brokerages. Bonds bought indirectly through Incapital are transferrable.

Your dermatologist has the best advice. Stay out of the sun.

•