

Elon in the mirror

Evan Lorenz writes:

The Ford Mustang Mach-E, the Tesla Model Y and the Hyundai Ioniq 5 have more in common than the lithium-powered batteries on which they run. Each highly rated electric vehicle is on sale today for immediate delivery with generous manufacturers' incentives. One year ago, would-be buyers queued up for the privilege of paying full price.

America's auto market, even now not entirely free of Covid-19's side effects, is one topic at hand. The wobbly American consumer is another. In preview, we remain bearish on the world's most successful EV maker, Tesla, Inc. (TSLA on the Nasdaq). Toward Asbury Automotive Group, Inc. (ABG on the New York Stock Exchange), the nation's fifth-largest auto retailer, and a December pick-not-to-click, we have warmed to the point of neutrality.

When the virus hit, "factories shut down and global supply chains were disrupted," Charlie Chesbrough, senior economist at Cox Automotive, Inc., reminds us. "We were living off of existing inventories for the most part through the next nine months. Factories started coming up, but volumes were significantly lower."

"Then, in the spring of 2021, we had a very hot market," Chesbrough goes on. "In March, April and May of 2021, vehicles were flying off the shelves. The vaccine was out, we had the new administration and the \$1,400 stimulus checks."

You could feel the heat in dealer lots, where inventories plummeted to around 1 million units in early 2022 from around 3.5 million pre-Covid. Their hearts set on a new ride, buy-

ers settled for a used one, and in the process they drove up the price of pre-owned cars by 67.4% between year-end 2019 and the close of 2021.

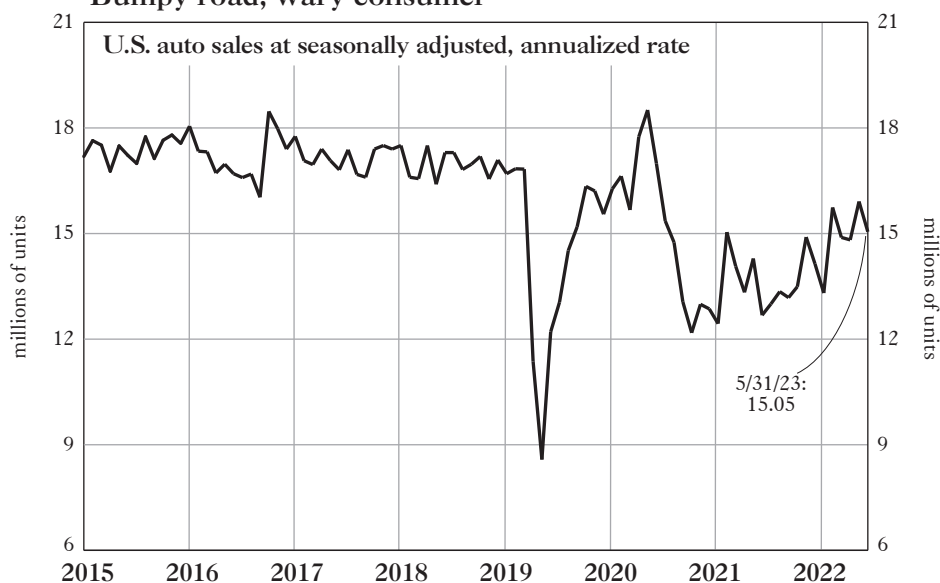
Lean inventories, it turned out, helped the entire industry. Original equipment manufacturers that couldn't boost production raised prices instead. General Motors Co. almost doubled its operating margins, to 7.9% last year from 4.4% in 2019. Tesla, with new capacity to spare, capitalized on burgeoning interest in electric vehicles and a virus-depleted competitive field to register sales growth from 2020 through 2022 at a compound annual rate of no less than 60.7%.

Tesla was the exception. Overall vehicle sales plummeted, to an average of 14.4 million units per year between

2020 and 2022 from a 17.2 million pace in the three years before Covid. Yet the auto dealers never had it so good. From August 2021 through October 2022, the average new vehicle sold at a premium to its manufacturer's suggested retail price, and the gross profit that Asbury earned per new car sold surged to \$5,583 in 2022 from \$1,516 in 2019. Over the same span, Asbury's earnings per share leapt to \$44.61 from \$9.55, with some assistance from acquisitions along the way.

Now bulls contend that the automakers, having learned their lesson, will continue to build fewer vehicles in the interest of earning greater profits. "I think the OEMs are going to be a lot more efficient and better at days'

Bumpy road, wary consumer



source: The Bloomberg

supply," Asbury CEO David Hult told his audience on the April 25 earnings call. "As long as we can keep days' supply in check, we think we can maintain healthy margins for the next couple of years. Although they may drop some, we don't see 2019 coming back anytime soon—if at all, ever."

Of course, good intentions sometimes fall victim to the error of the people who make them. A return to overproduction would lead to excessive inventories and margin-shrinking sales incentives. Besides, softer prices on new vehicles would infiltrate the used-car market. As almost every automotive transaction involves a trade-in, lower used-vehicle values would reduce consumer purchasing power and thereby pressure auto-dealer profits.

"[W]hatever else the 21st-century auto-manufacturing industry may be, it's no production-rationing oligopoly," we laid it down in our Dec. 23, 2022 analysis of Asbury. In May of this year, new-car inventories rose by 71% from the year-earlier level, to 1.9 million units, or a 52-day supply at current sales rates, according to Cox Automotive. Though well below the 3.5 million pre-2020 average, it's nothing to sneeze at.

It's an uneven increase, with Stellantis N.V. nameplates Ram, Jeep and Chrysler showing more than 90 days' worth of inventory and Toyota Motor Corp. with fewer than 30. Inducements are returning, also unevenly. The Jeep and Ram marquees, for example, offered incentives of around 6% of their average transaction prices in May while Toyota's deals amount to just 2%.

Surprisingly, the biggest inventory build has been in the hottest corner of the auto market: electric vehicles. Sales rose 45% year over year in the first quarter, driving the market share of EVs to 7.2% from 4.6%. But the production of lithium-powered vehicles is rising even faster than sales, with days' worth of inventory bulging to 92.2 as of June 30, up from 61.1 at year-end and 35.8 in June last year, according to Cox Automotive.

Still, EVs remain a niche product, the hoopla notwithstanding. Public charging stations are not always where you need them, and not everybody has a garage. Affordability is another sticking point. Between December 2019 and May 2023, the average price of a new internal-combustion vehicle jumped by 24.6% to \$48,528, according to Kelley Blue Book. The average new buyer

financed at a 7.1% rate in the three months ended June, up from 5% in the same period last year and a low of 4% in 2020. The combination of higher prices and higher interest rates meant that 17.1% of borrowers in the second quarter drove off dealer lots owing monthly payments of more than \$1,000. That compares with just 4.3% of borrowers who paid such freight in the same quarter of 2019. For reference, median household income was \$70,784 in 2021.

The captive finance units of OEMs, by pricing loans to keep production rates humming, confer a built-in advantage to new-car buyers. Double-digit borrowing costs nowadays greet used-car shoppers—CarMax, Inc., America's largest dealer in used vehicles, quoted an average of 11.1% in the three months ended May.

Despite a Tesla-driven drop in average electric prices of \$9,370 in the 12 months ended May 2023, EV stickers can still deliver a shock. While the Inflation Reduction Act dangles a tax credit of up to \$7,500 on new electric vehicles, the subsidy doesn't apply to all models (there are domestic content requirements) and can be extended in full only to buyers with a tax liability of at least \$7,500. In May, the average EV sold for \$55,488, or a \$6,960 premium to the average gasoline-powered model.

The closing of the student-loan payment holiday, slated for October, will hardly enhance the affordability of any product or service (the average monthly loan-payment tab is expected to reach \$413). Notable, then, are the problems already percolating in auto credit.

A June 30 Citigroup, Inc. report noted that bonds backed by subprime loans issued by U.S. Auto Sales and American Car Center, a pair of used-car dealers that declared bankruptcy earlier this year, may not repay principal in full. Such a default would be the first since the Clinton administration. Some of the bonds in the U.S. Auto Sales securitization change hands at 18 cents on the dollar as over-collateralization cushions have tumbled to 5.5% from an initial target of 35%.

But it's the big OEMs themselves that pose the top threat to the EV market. Each vows to pivot large portions of sales away from gas-guzzlers over the next decade. Volkswagen A.G., for example, targets shifting 80% of its European sales and 55% of its North American sales to EVs by 2030. To do this, the German

automaker says it will spend around \$130 billion on electric-vehicle capacity over the next five years. But has anyone checked with the customers?

"We are experiencing strong customer reluctance in the electric-vehicle sector," Manfred Wulff, a VW plant manager in Emden, Germany, lamented a fortnight ago. Sales are running 30% below internal forecasts, he said, and Volkswagen is laying off 300 of its 1,500 workers at that factory and plans to shut down production in Emden for six weeks.

The trouble is that the automakers don't have much choice. Only listen to Ford Motor Co. CFO John T. Lawler on the May 2 earnings call: "Now the profitability of any EV startup, including Ford Model e [i.e., the company's EV division], is highly levered to volume.... We expect the Ford Model e Ebit margins to improve to around negative 20% in the second half of this year, reflecting stronger per unit contribution margins and significantly higher volumes." They had better. In the first quarter, Ford generated \$707 million's worth of green-vehicle sales—and \$722 million in red ink, for an operating margin of negative 102.1%.

Which brings us back to Musk & Co. "Tesla is starting a little bit of an EV price war to get its own factories utilized because they've added a tremendous amount of capacity into a highly competitive environment," Jay Van Sciver, who rates the stock a sell for Hedgeye Risk Management, LLC, tells me. "So they added capacity in Germany. They added capacity in Texas to produce the Model Y into what ended up being a much more competitive environment that saw their market share erode. As a result, they are discounting really aggressively."

New models fairly tumble off the production lines of Tesla's competitors. "[I]t's hard to keep track of them," Van Sciver goes on. "We used to keep a spreadsheet of all the electric vehicles, but at some point in the last few months we just gave up. The electric Escalade was just too far."

The oldest Tesla model, the Model S, debuted in 2012; the newest, the Model Y, arrived in 2019; the two constitute 50% of the entire Musk product lineup, not counting the Cybertruck, an electric pickup, which is expected to enter production in the second half of 2023. Or maybe the Cybertruck will not enter production this year—2021

Tesla, Inc. at a glance

all figures in \$ mns except per share data

	<u>TTM*</u>	<u>2022</u>	<u>2021</u>	<u>2020</u>	<u>2019</u>
sales	\$86,035	\$81,462	\$53,823	\$31,536	\$24,578
operating income	12,716	13,656	6,523	1,994	-69
net income	11,782	12,587	5,655	862	-862
earnings per share	3.40	3.62	1.63	0.21	-0.32
share outstanding	3,468	3,475	3,386	3,249	2,655
cash	22,402	22,185	17,707	19,384	6,268
debt	2,676	3,099	6,834	11,688	13,419
total assets	86,833	82,338	62,131	52,148	34,309

* For the 12 months ended March 31, 2023.

source: company reports

was to have been the certain date. Like many an author, Tesla is an habitual blower of deadlines. Anyway, Cybertruck, when it does arrive, will encounter competition from the likes of the Ford F-150 Lightning, the Rivian R1T and the Hummer EV, among others.

Overpromising takes other forms at Tesla. On the April 19 earnings call, Musk announced that the company's Full Self-Driving software had racked up 150 million customer miles. Adding color to that statistic, the National Highway Traffic Safety Administration (NHTSA) reports that Tesla's driver-assistance software has been implicated in at least 736 crashes, resulting in 17 fatalities.

"[T]hat implies a fatal-accident rate of 11.3 deaths per 100 million miles traveled," a June 14 article in *The American Prospect* points out. "The overall fatal accident rate for auto travel, according to the NHTSA, was 1.35 deaths per 100 million miles traveled in 2022. In other words, Tesla's FSD system is likely on the order of 10 times more dangerous at driving than humans." The NHTSA pressed Tesla for more records on its driver-assistance software last week as part of the agency's investigation into the EV company (threatening a daily fine of \$26,315 for failure to comply).

Then there's the inimitable Musk himself. The Tesla CEO has declared himself an enemy of the "woke mind virus" and recently banned the words "cis" and "cigender" on his social media network, Twitter, red meat for right-wing audiences. Unfortunately, not a few EV buyers identify as liberals. (According to an April poll by Gallup, 71% of Republican respondents said

they would never buy an EV; only 17% of Democrats said the same.)

At Tesla, too, let the record show, demand curves slope downward and to the right. Thus, thanks to heavy discounting, the first quarter delivered a 24% jump in revenue—but a 23% decline in earnings. At that, things would have been worse without "regulatory credit sales" in the sum of \$521 million (almost double the amount the Street expected). Such credits are "100% margin," observed JPMorgan Chase & Co. analysts in April. But Tesla's competitors, who have been paying these "credits" (perhaps with gritted teeth), will stop paying as their own EV production ramps up.

And here's a nugget from Emmanuel Rosner, analyst at Deutsche Bank A.G., following his participation in a management-led tour of Tesla's Austin, Texas, manufacturing plant in May: The company "reiterated that the environment could get more challenging in the next 12 months, and the company remains committed to growing volume as long as it generates positive free cash flow, suggesting to us the theoretical margin floor is quite a bit lower than recent levels." New Tesla is sounding like Old Detroit.

Since the start of the year, Tesla's share price and fundamentals have gone in opposite directions. Thus, the stock has vaulted by 119% to \$269.79, or a 1.7% premium to when we laid out the bear case in the issue of *Grant's* dated Sept. 30, 2022. Meanwhile, Street estimates for 2023 EPS have dropped to \$3.49 from \$5.33, thereby lifting Tesla's ratio of price to 2023 estimated earnings to 77.3 times from 23.1 times.

Awestruck by this gravity-defying performance, 20 of the 49 analysts cov-

ering the stock call it a buy; 9, a sell. Short interest amounts to 3.5% of the equity float versus a three-year average of 4.3%. To date this year, insiders have unloaded 229,399 shares for net proceeds of \$45.9 million against no buys.

...

Asbury, the fifth-largest automotive retailer in the United States, operates 139 new-car dealerships and 32 collision centers and retails 31 different brands. It sold nearly 300,000 vehicles in the 12 months ended March 31, roughly split between new and used. Imports (Toyota, Honda, Hyundai, etc.) produced 38% of first-quarter sales, luxury models (Lexus, Mercedes-Benz, BMW, etc.) chipped in 34% and domestic nameplates (Stellantis, Ford and GM) accounted for 28%.

The bear arguments we advanced in December held that growing production and mounting inventories would hasten the return of deep discounts, pre-Covid gross margins and much lower net income. Since we said our piece, Asbury's share price has disobediently risen by 48.4%.

Our thesis is playing out, albeit slowly. In the first quarter, measured year over year, gross profits fell by 9% for each new vehicle sold and by 15% for each used one; EPS fell by 19%. While the profits on used vehicles are only 42% above their pre-Covid level, gross profits per each new vehicle remain 242% above the 2019 level.

"It's actually been a more modest pace of normalization than we thought it would be," Daniel Imbro, who rates Asbury a buy for Stephens, Inc., tells me. "We expect that maybe the back half of 2024 will be when we get to whatever the new normal [is for gross profits]."

A recession would likely accelerate the return to normality, though auto dealers are somewhat recession-resistant by nature. Parts and service departments, which, in Asbury's case, made up 41% of the first quarter's gross profits, tend to shine in a downturn. Rather than buy, motorists tend to fix, and it's the manufacturers that pay the freight for the warranty work the service departments perform.

"It's a very good industry because it is capital-light from the standpoint that all their inventories are effectively financed by the OEMs, more or less, or banks," Adam Schwartz, the chief

investment officer of Black Bear Value Partners, which holds a position in Asbury, tells me. "When sales are down, dealers sell down their inventory and pay down their debt. So, when things slow down, they actually generate cash."

A quick return to 2019-level profitability would please the bears, but events are moving at their own deliberate place, and

dealers may retain some of their virus-boosted profit levels. Assuming that profitability on new and used vehicles remains 30% above the pre-2020 level and that volumes recover by an additional 15%, Asbury might generate \$20.31 in EPS. While this would be half of trailing earnings of \$42.60, at an 11.1 times multiple, the average Asbury commanded in the

five years ended 2019, the stock would be worth \$225.46 versus a current share price of \$250.85.

Tesla, by contrast, faces not only the full brunt of increased auto production and a return to discounting, but also, while looking in the mirror, the source of those problems. It's you, Mr. Musk!

●

*Grant's® and Grant's Interest Rate Observer® are registered trademarks of Grant's Financial Publishing, Inc.
PLEASE do not post this on any website, forward it to anyone else, or make copies (print or electronic) for anyone else.
Copyright ©2023 Grant's Financial Publishing Inc. All rights reserved.*