

Q3 2019 Tesla Inc Earnings Call Transcript

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Operator

Ladies and gentlemen, thank you for standing by, and welcome to Tesla's Q3 2019 Financial Results and Q&A Webcast. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference to over your speaker, Mr. Martin Viecha, Senior Director of Investor Relations. Please go ahead.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Thank you, Sherrine. And good afternoon, everyone. Welcome to Tesla's Third Quarter 2019 Q&A Webcast.

I'm joined today by Elon Musk, Zachary Kirkhorn and a number of other executives. Our Q3 results were announced at about 2 p.m. Pacific Time in the update deck we published at the same link as this webcast.

During this call, we will discuss our business outlook and make forward-looking statements. These comments are based on our predictions and 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 filings with the SEC. (Operator Instructions)

But before we jump into Q&A, Elon has some opening remarks. Elon?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Thank you. First of all, I'd like to just thank the Tesla team for an incredible job this quarter. The execution was outstanding and on just about every front. So it's just an honor to work with such a great team.

Q4 -- Q3 was obviously a very strong quarter. And we had record deliveries. We're able to make great strides in controlling our costs. We shifted back to GAAP profitability while also generating strong free cash flow. And again, this would not be possible without each employee doing their part to reduce cost. Our operating cost is now at the lowest level since Model 3 production started.

Regarding Gigafactory Shanghai, this month, we started trial production at Giga Shanghai in both vehicles from body to paint to general assembly. So this is a -- I want to emphasize, this is a real factory with a tremendous amount of equipment in it. While a lot of people see the outside shell of the factory, which is enormous and it was essentially underwater in January, it was just below the water table literally, what is, I think, much more significant is that we're able to install massive stamping machines, a fully operational paint shop and a sophisticated general assembly line in the same period of time in parallel with building the building.

I'd like to thank our entire team for this extraordinary achievement. I'm not aware of any factory of this magnitude in history being constructed in such a short period of time, approximately 10 months. As far as I know, this is unprecedented. And Gigafactory Shanghai will become a template for future growth. We're planning to build Model Ys in Shanghai as well, of course, and build a Gigafactory in Europe. And we hope to announce the location of that Gigafactory -- in fact, we will announce the location of that Gigafactory before the end of this year.

Regarding Model Y, we're also ahead of schedule on Model Y preparations in Fremont. And we've moved the launch time line from fall 2020 to summer 2020. There may be some room for improvement there, but we're confident about summer 2020.

I've actually recently driven the Model Y Release Candidate, and I think it's going to be an amazing product and be very well received. I think it's quite likely to -- it's just my opinion, but I think it will outsell S, X and 3 combined.

Regarding Version 10 and Smart Summon, last month, we released our latest software, Version 10, which includes video streaming, games, karaoke, Spotify and a host of other new features and improvements. Most importantly, it includes the first version of Smart Summon, which has now been used 1 million times. So it's now over 1 million users of Smart Summon. And we're -- in the next week or so, we will be releasing an improved version of Smart Summon, taking into account all the data from those 1 million Smart Summon attempts.

So this really illustrates the value of having a massive fleet because it allows us to collect these corner cases and learn from them and use fleet learning and become rapidly better, just as Navigate on Autopilot did on the freeway. So expect a number of improvements in Smart Summon in the weeks to come. And this really is just the beginning as we collect more data and Autopilot and Full Self-Driving functionality gets better.

I do -- while it's going to be tight, it still does appear that we will be at least in limited -- in early access release of a feature-complete Full Self-Driving future this year. So it's not for sure, but it appears to be on track for at least the early access release of a fully functional Full Self-Driving by the end of this year.

And yes, lastly, we're highly focused on decisions that really make a material difference to the company such as opening Gigafactories in other continents. Yes, it's worth noting that these -- ultimately, having 3 Gigafactories, effectively, we'll actually triple our output. And then when you consider increased output per Gigafactory, it's going to actually more than triple our output over time.

And then there are a lot of interesting things happening with respect to advanced batteries and more efficient powertrains and Full Self-Driving, all that sort of stuff. But that will be something for a future time.

And then one last item is that tomorrow afternoon, we will be releasing version 3 of the Tesla Solar Roof. That's the integrated solar -- with solar panels integrated with the roof. So that's -- I think this is a great product. Version 1 and 2, we're still sort of figuring things out. Version 3, I think, is finally ready for the big time. And so we're scaling up production of the version 3 solar tower roof at our Buffalo Gigafactory. And I think this product is going to be incredible. But we'll talk more about that on the official product launch, which will be tomorrow afternoon.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Thank you very much. And I think Zachary has some remarks as well.

Yes. Thank you, Elon. Thank you, Martin. Q3 was a great quarter for Tesla. I know many employees are listening right now, and I want to thank you for your passion and your hard work. We've made terrific progress, and yet again, we realized margin improvement in nearly every aspect of the business.

There are 3 key points I'd like to highlight. First, we returned to profitability in Q3, aided by improved gross profit, reduced operating expenses in the absence of negative onetime items that weighed on our financials in the first half of the year. GAAP automotive gross margin improved sequentially to 22.8% and over 20% excluding regulatory credits.

We achieved these improvements through higher production volumes on S/X and Model 3, enabling better fixed cost absorption. We realized improvements in labor hours per vehicle as well as other costs such as warehousing, logistics, delivery and import-related items. We're also making continued progress reducing material costs, including commercial negotiations with suppliers.

Model S and X ASPs increased even accounting for revenue deferrals related to free unlimited supercharging. And Model 3 ASPs declined slightly driven by mix in Asia, pricing action in EMEA. North American ASPs held flat as mix improved, offsetting pricing action we took at the start of the quarter, which is great to see.

Note that with the release of Smart Summon in the U.S., we were able to recognize \$30 million of deferred revenue. As we expand Smart Summon to additional markets and release new features, we'll continue to recognize additional deferred revenue.

Our services and other loss reduced yet again, reflecting our focus to improve the efficiency of this area of the business. And we further reduced operating expenses despite increased orders, deliveries and new programs in development.

And finally, on net income -- in other income, we saw benefits from foreign exchange which, as I mentioned last quarter, we don't hedge.

The second key point I want to highlight is that we demonstrated another quarter of strong free cash flows despite a significant increase in our captive leasing mix and a sequential increase in CapEx spend. This has enabled year-to-date positive free cash flows for the company. Our cash balance increased by approximately the same amount as our free cash flows, and we exited the quarter with our highest quarter ending cash balance ever of just over \$5.3 billion.

Specifically, on captive leases, we received a number of questions on how these are funded. We use our leasing warehouse and ABS sales to allow for captive leases without material use of cash. What's important to note here is that our warehouse and ABS flow through financing cash flow and, as a result, leases negatively impact free cash flow. This impact was material in Q3 as the lease rate increased substantially by 50%.

In addition, CapEx spend increased driven primarily by Gigafactory Shanghai and Model Y spending. We received a number of questions on why our capital spending appears low compared to prior levels even though there are multiple new projects launching and in development. As we noted in the shareholder letter this quarter and last quarter, this is because we've made great progress on improving our capital efficiency.

My third and final point is around demand and growth. Our global order rate remains strong and continues to increase. Despite increases to production levels, our order backlog has been growing. And quarter-to-date orders are significantly higher than at this point in last quarter.

In the immediate term, we're focused on increasing production of Model 3 and Model S and X as quickly as we can. The bulk of this work involves continued optimization of existing equipment. We've also made targeted adjustments to pricing to better balance supply and demand. Our pace of execution on these factories and capacity expansion has increased significantly. As Elon mentioned, the first phase of Gigafactory Shanghai is already production-ready, and we've been able to pull in the time line for other major projects.

Overall, we are quickly turning the corner for our next phase of growth, and our financial health continues to strengthen. We remain focused on reducing cost, which enables rapid investments in future programs and growth.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Thank you very much, and I think also, our Senior Director of Energy Operations, Kunal Girotra, wanted to add some remarks.

Kunal Girotra - *Tesla, Inc. - Senior Director of Energy Operations*

Hi, everyone. My name is Kunal Girotra, and I've been with Tesla for about 4 years, working on different aspects of deploying our energy products. I now run Tesla Energy's deployment and fulfillment teams.

Over the last 3 months, the energy teams have made great progress in both our solar and energy storage businesses. As you can see in our quarterly deck, our solar deployments rose by almost 50% over the last quarter. And our energy storage deployment, which includes Powerwalls and Powerpacks, grew by 15% to an all-time high of 477 megawatt hours.

In the last 3 months, we relaunched Tesla solar in North America by simplifying our solar offering into 3 sizes of small, medium and large. We're transferring pricing on the website.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Actually, if I may interject a minute, but what a lot of people don't realize is in -- like in California and in a number of other states, if you buy our sort of solar subscription or solar rental, there's no money down and you instantly save on your utility bill and there's no long-term contract. So it's kind of a no-brainer. It's really do you want something that prints money? And if it doesn't print money, we'll fix it or take it back. It's kind of a no-brainer. And it sort of plays into Tesla's overarching strategy here, which is effectively to become like a giant distributed global utility on the energy front.

Kunal Girotra - *Tesla, Inc. - Senior Director of Energy Operations*

Yes, absolutely. The subscription solar offering that you mentioned was launched in 6 states. And like you said, it's fixed monthly payments and no long-term contracts. And the response from customers have been pretty awesome.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Most people do actually buy it as opposed to rent it, which is actually technically the better -- while you make money is immediately if you're rental, it's actually a better investment if you buy it because the cost of capital of the consumer is better than our cost of capital.

And then there was like an interesting study by Zillow and a number of other organizations that

show that adding solar to your home increases the price of -- increases the value of your home. And the Zillow study showed a 4% increase in the value of the home with solar. And then if you add sort of the Powerwall, which gives you blackout protection, so you will have energy security in an event of rolling blackouts or if the power goes up for any reason, which appears to be a long-term systemic issue in California particularly, that I think this definitely can be viewed as a significant asset for any home.

Kunal Girotra - *Tesla, Inc. - Senior Director of Energy Operations*

Totally, yes. Yes, I think to your point of buying Tesla solar is easy because we have one of the lowest prices in the nation now -- in the country. And just a little bit of a story there, we were able to lower our prices because our cost of acquisition is now less than 1/4 of any typical solar company.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

We don't do sales.

Kunal Girotra - *Tesla, Inc. - Senior Director of Energy Operations*

Yes. These are online sales, online orders.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

There's no advertising, no marketing and no sales force. But would you rather pay for power or for marketing? Yes. I'd say you'd rather pay for the product.

Kunal Girotra - *Tesla, Inc. - Senior Director of Energy Operations*

Totally, yes, yes. All right, that's great. On solar, we want to simplify the fulfillment process with a goal of really fast order-to-install time lines. We've done many residential installs with a single visit to a customer's home because the standard sizes are reduced complexity. We've also been working with cities and counties to submit generic permits that follow a template rather than customizing for every situation because...

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. Actually, Kunal, this is a really big deal. That's like the ones people won't appreciate. It's great work by you and the energy team to get those signed because one of the inhibitors, both from a cost and timing standpoint, is getting permit approval from the various regional authorities of -- and we've pioneered a novel approach. It's sort of an innovation applied to bureaucracy, frankly, which -- interfacing your client innovation to try anything. And every button -- a massive number of housing approval authorities to take a generic template as opposed to a custom template, which makes it (inaudible) and in most cases, I think electronic as well. So that just makes it simple and low cost and fast to get approval for solar, which is how it should be.

Kunal Girotra - *Tesla, Inc. - Senior Director of Energy Operations*

Totally. Yes, around 350 cities and counties have accepted it. There is still about...

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

And more coming.

Kunal Girotra - *Tesla, Inc. - Senior Director of Energy Operations*

Many more coming.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. I think ultimately, it will be almost everyone.

Kunal Girotra - *Tesla, Inc. - Senior Director of Energy Operations*

Yes, yes. We have a lot more small cities and counties that have to come online, but that will be our focus in the coming days. And it's more important as we scale Solar Roof 2 for all our -- deploying energy products needs innovation and in the bureaucracy space, as you said as well.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. I mean, yes.

Kunal Girotra - *Tesla, Inc. - Senior Director of Energy Operations*

Yes. So all these improvements have led us to speed up our customer order-to-installation time lines from months to, in many cases, days. As, Elon, you already said, we've added the option to add Powerwalls to secure people from future power outages. And a home with solar and Powerwall, as was shown in the recent California outages, many homes ran successfully.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. You can tell which homes have Powerwall because that's where all the light -- that's where the lights are on. Yes, if you look at the neighborhood, it's like oh, there's -- everywhere but a few lights around and those are usually the ones with the Tesla Powerwall. I think -- I don't -- I'm not sure if you're going to mention, but also like the single truck roll. It's likeâ

Kunal Girotra - *Tesla, Inc. - Senior Director of Energy Operations*

Single site visit, yes. Single-visit install.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. Single-visit install is a big deal. We're taking it from where the solar industry would often be 3 visits before the solar was installed and would often take quite a long time to do the installation. But we streamlined all of that to a point where, in many cases, it's a single visit to do everything, and it's fast. So it's like minimize disruptions to the homeowner. And ordering solar is literally 1 click. You can order solar for your house in less than 1 minute. So...

Kunal Girotra - *Tesla, Inc. - Senior Director of Energy Operations*

Yes. And then we've done the same thing in the commercial solar space. Nobody thought of putting a simple website with order -- with prices for commercial solar. We do that now. And we've seen a good response from small businesses wanting to go solar. And by removing the complexity of long-term contracts and simplifying the terms and conditions, the commercial solar sales process would typically take 6 months is now taking a couple of weeks. So the same thing that we've done in residential, we want to expand more and more in commercial as well.

So all in all, the road map for energy products from solar, Solar Roof, Powerwall to Megapack is

super exciting. And I expect Tesla Energy to become a larger part of our overall ecosystem as we leverage and integrate the same competencies from our vehicle business. The future is pretty exciting for Tesla Energy.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Great.

Kunal Girotra - *Tesla, Inc. - Senior Director of Energy Operations*

Thanks again.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Thank you very much. So first, we're going to take some questions from say.com. We will, this time, take questions from both institutional investors as well as retail investors.

Questions and Answers:

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

So the first question from institutional investors is, what are the opportunities for Tesla to create demand? Is word-of-mouth still sufficient? Or should we expect to see Tesla commence advertising in the near future?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. What we're seeing is that word-of-mouth is more than enough to drive our demand in excess of production. We have no plans to advertise at this time. Obviously, at some point in the future, we may do advertising, not in the traditional sense but more to just inform people and make sure that they are aware of the product, but not engage in the typical trickery that is commonplace in advertising.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Okay. The next question from institutional investors. Elon, other than robotaxis and autonomous vehicle capabilities, when you look over the next 3 years, what are you most excited about at Tesla that you believe investors don't understand or have missed?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

I think there's generally a lack of understanding or appreciation for the growth of Tesla Energy, as Kunal was talking about. In the long term, I expect Tesla Energy to be of the same -- roughly the same size as Tesla's automotive sector or business.

This is the most underappreciated. I think it could be bigger, but it's certainly of a similar magnitude, Tesla solar, meaning Tesla solar plus battery stuff is -- to Tesla Energy is, I think, the least appreciated element. And part of it is like for -- I don't know, for about 18 months, almost 2 years, we had to divert a tremendous amount of resources -- well, we had to basically take resources from everywhere else in the company and apply them to the Model 3 production, fixing the Model 3 production ramp and simplifying the design of Model 3.

So for about 1.5 years, we unfortunately stripped Tesla Energy of engineering and other resources

and even took the cell production lines that were meant for Powerwall and Powerpack and redirected them to the car because we didn't have enough cells. Now that we feel that Model 3 production is in a good place and headed to a great place, we've restored resources to Tesla solar and storage. And so that's going to be, I think, the really crazy growth for as far as future as I can imagine.

But we had to do it because if we didn't solve Model 3, Tesla wouldn't survive. So unfortunately, that shorted pretty much the other parts of the company. But it would be difficult for me to overstate the degree to which I think Tesla Energy is going to be a major part of Tesla's activity in the future.

And, I mean, Tesla's mission from the beginning has been to accelerate the advent of sustainable energy. That means sustainable energy generation and sustainable energy consumption in the form of vehicles, electric vehicles. And I think one of the stats we'll publish in the future along with our vehicle production is that how much sustainable energy Tesla produced or Tesla customers produced with our products. And I think you'll see that we're producing about the same or comparable amounts of sustainable energy as are consumed in the car -- in our cars. Because for the longest time, the rebuttal against electric cars are like oh, don't they use dirty power from coal? Well, no, we're solar-powered. And that's -- obviously, there are solar power companies, not just Tesla. But you have to sell sustainable generation and sustainable consumption, and that's what we're doing, and we'll do more of it.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Okay. Thank you. The next question from investor is related to Full Self-Driving attach rates. Given that self-driving regulations will evolve unevenly in different markets, would you consider selling modules individually, for example, Navigating on Autopilot or Summon versus current strategy of selling the package as a whole in order to encourage adoption and getting more data?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

I think we'll continue to sell it in a bundled fashion. I mean, any Tesla that you buy already has basic Autopilot included. So I think that really is a pretty major advantage relative to other cars. And then the next step will be Full Self-Driving with Smart Summon being kind of the beginning of that.

And obviously, we kind of have the 2 sides of it with highway Autopilot and we've got the Summon, which is sort of low speed and talking less, that kind of thing. Now we need to -- we're working on solving that intermediate portion, which is traffic lights and stop signs and navigating through windy roads and -- windy, narrow roads and suburban neighborhoods. That's the focus right now. And you're going to want it all, right? I think it's -- yes, it's something that everyone's going to want, for sure.

And as I said before, the point at which we're able to upload the software enabling a Tesla to become a robotaxi, expect to have that from a functionality standpoint by the end of next year. But in terms of the functionality -- so basic functionality is aspirationally end of this year, but reliable enough that you do not need to pay attention, in our opinion, by the end of next year. And we would need -- the acceptance by regulatory authorities will vary by jurisdiction. That transition, that sort of flipping of the switch from a car that is from not robotaxi to robotaxi, I think will probably be the biggest step-change increase in asset value in history by far.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Okay. Thank you. The next question is with respect to Model Y, what is your latest expectations for launch timing? Do you anticipate any Model 3 production downtime at Fremont during the launch?

And how should Model Y gross margin percent look compared to Model 3 gross margin?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Well, we've talked about the launch timing. What really matters is the timing to volume production, where volume production is some number in excess of 1,000 units per week. And we're confident of reaching that point no later than the middle of 2020.

The -- yes, so from an interference standpoint, we do not expect it to interfere. Yes. The body line is separate. The paint line is. So basically, we do not expect it to interfere with Model 3. We do not expect any downtime. From a margin standpoint, Zach, do you want to...

Zachary Kirkhorn - *Tesla, Inc. - CFO*

Yes. From a margin perspective, we're expecting ASPs for Model Y to be slightly higher than they are for Model 3. And this is common in the industry between sedans and CUVs. The part that we've worked very hard on is controlling the cost of Model Y. And our steady-state forecast for that program puts the cost at roughly equivalent to Model 3. So there will be ramp inefficiencies at first, of course, as we launch the program. But as it stabilizes with steady-state production, we do expect that it will be a higher-margin product. It's something that we're very excited about within the company.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Okay. Thank you. And the last question from institutional investors is, can you provide an update on FSD package attach rates? As FSD attach rates improve, will you let the financial benefits manifest in higher gross margins for company and shareholders? Or will you lower the price to drive delivery volume?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

I don't think we're going to need to lower the price of FSD. But I expect the price of FSD to increase slowly as the functionality and capability improve. That's -- that is unchanged. Anything you want to add? I mean, our cash gross margin obviously is higher than our GAAP gross margin because of unrecognized revenue associated with FSD attach rates. So that's why I think it's in the order of \$600 million or in the order of \$0.5 billion...

Zachary Kirkhorn - *Tesla, Inc. - CFO*

\$500 million.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

\$0.5 billion of unrecognized revenue. So if you were to include that, which would obviously be recognized as we release the Full Self-Driving functionality, but actual gross margin that we're operating on, on a cash basis today is higher than the GAAP gross margin.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Okay. Let's now go to questions from retail investors. The first question from Craig is, can you provide more detail on the DeepScale acquisition, its importance and whether Tesla is still on track to recognize and respond to traffic lights and stop signs with automatic driving on city streets by the end of 2019?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Sure. DeepScale is a very tiny company. It's basically about 12 people. And it's -- they have some expertise in increasing the efficiency of neural net for a given amount of compute, which I think is helpful. So it remains to be seen. But the intent behind what was a very tiny acquisition, was to, I think, slightly accelerate FSD. That's the intent. And hopefully, that will turn out to be true. Yes.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Okay. The second question, we've already answered regarding Model Y delivery. So we'll jump to the third question from Craig. News reports suggest that Gigafactory 3 already -- may already be producing Model 3s for Chinese markets. Could you please update us on the production expectations for Giga 3 and confirm purpose of the second building now being built? Is that for battery production as suggested by some press outlets?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. We're in trial production of Model 3. We're basically sending cars through the system, and we're ramping rapidly. We're expecting to hit volume production in a few months essentially.

The second building is, indeed, for battery and module production. And that's probably going to -- because there's obviously a bunch more construction beyond what's already there because obviously, we need to build out facilities for Model Y production at Shanghai as well.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Okay. The next question from retail investors is, can you update us on the initial results of Tesla car insurance? Is there a time line to expand it nationally and internationally?

Zachary Kirkhorn - *Tesla, Inc. - CFO*

Yes, I can take that. So far, we've launched Tesla Insurance in California. I have to say that I'm quite pleased by the results so far. The take rate, as measured by quote-to-purchase conversion are quite high by industry standards. And we expect that this will only increase as folks understand the products better and receive some of the known price increases coming from some of the standard carriers that they'll come to us and look for an alternative.

There's a bunch of work happening behind the scenes on improving the product, particularly the purchase flow, to make sure it's the best product experience for our customers. And we're also working very hard to get other states lined up in the States and then also to launch in some countries internationally. So we're not able to provide specific time lines on those changes, but we're definitely working as quickly as we can given how well received Tesla Insurance has been in California.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. I think it also has a secondary effect of ensuring that the third-party providers of insurance provide reasonable rates to our customers.

Zachary Kirkhorn - *Tesla, Inc. - CFO*

I completely agree. The goal here is not to have an outsized market share of insurance. It's just to make sure that customers have an alternative to other companies as well if those rates are high. I mean ultimately, what makes the most sense for total cost of ownership perspective is for folks to

have good pricing on their insurance.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes, exactly.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Okay. And the last question from retail investors. There's skepticism regarding your comment that the Full Self-Driving will be feature-complete by year-end, like resulting from confusion about feature-complete, what feature-complete means. Could you please talk to this and perhaps give us a list of features that establish the FSD baseline?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Feature-complete, I mean, it's able -- the car's able to drive from one's house to work, most likely without interventions. So it will still be supervised, but it will be able to drive -- it will fill in the gap from low-speed autonomy -- we've got low-speed autonomy with Summon. We've got high-speed autonomy on the highway. And we've got intermediate speed autonomy, which really just means traffic lights and stop signs.

So feature-complete means it's most likely able to do that without intervention, without human intervention, but it would still be supervised.

And I've gone through this time line before, I think, several times. But it is often misconstrued. But there's like -- there's 3 major levels to autonomy. There's the car being able to be autonomous but requiring supervision and intervention at times; that's feature-complete. Then there's -- and it doesn't mean like every scenario, everywhere on earth including every corner case. It means most of the time.

And then there's another level which is that we think it's -- that from a Tesla standpoint, we think the car is safe enough to be driven without supervision.

Then the third level would be that regulators are also convinced that the car can be driven autonomously without supervision. Those are the 3 different levels.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Okay. Thank you very much. Sherrine, we can now go to the questions from analysts.

Operator

(Operator Instructions) Our first question comes from Dan Galves with Wolfe Research.

Daniel V. Galves - *Wolfe Research, LLC - Director of Equity Research & Senior Analyst*

I was hoping that you could give us a little bit more color on sizing up the key factors in the auto gross margin improvement from Q3 to Q2. Particularly, you mentioned some nonrecurring items in the letter. And also, should investors be prepared for any meaningful headwinds as the China plant comes up but isn't at full production yet?

Zachary Kirkhorn - *Tesla, Inc. - CFO*

Yes. I can provide a couple of comments on that. So on your final -- on your last question about

China headwinds, there are always ramp inefficiencies when we launch a new factory. So we don't expect China to be any different than that. So there will be some that we experience in Q4. The amount of that is hard to forecast given that it's a different type of factory design than we did here in Fremont. We're working very hard to limit the ramp inefficiencies, but certainly, fixed cost absorption and having all of the labor ready as we ramp will have an impact on Q4.

And on the margin improvement, a couple of things there for auto gross margin. As I mentioned in my opening remarks, S and X average selling prices increased from Q2 to Q3. I mean that's important. As I mentioned in the last earnings call, the prior powertrain versions of S and X provided significant headwinds on average selling price for that product in the quarter.

We've also done a bunch of work as a company to become more targeted in how we adjust pricing on our products and how we optimize that based on local supply and demand. And so I think there's a bunch of good work from the team on that in Q3, which flowed through on our financials.

And cost reduction has just remained a huge focus for us. It's hard to underestimate how much of that has been ingrained in the culture of the company. And Jerome and his team have done absolutely tremendous work there. So on every line item of our cost, whether it be manufacturing, labor, warehousing, logistics, there's just a tremendous amount of good work that happened there.

Specifically on nonrecurring items, to that, I'll note one being the Smart Summon revenue recognition. Debatable whether that's considered recurring or not given that we continue to expect to release more features and release revenue associated with that in the future. But we did want to call that out specifically and the dollar value around that as we know there's been speculation around the impact for the quarter.

And foreign exchange is just something that, since we don't hedge, it has an impact. And it comes and goes every quarter. So we'll have to see if the quarter plays out the effect that, that has.

Operator

Our next question comes from Adam Jonas with Morgan Stanley.

George M. Dailey - *Morgan Stanley, Research Division - Research Associate*

This is George Dailey on for Adam. So first question. Is it a fair assumption to say that once the Shanghai Gigafactory has ramped, the Model 3s sold in China for China could be the most profitable car you sell, even more profitable than the average car made at Fremont right now?

Zachary Kirkhorn - *Tesla, Inc. - CFO*

That one is also difficult to forecast. It's a good question. At least based on the plans that we have now, we're expecting it to be roughly in line with where Model 3 is coming out of our Fremont factory. There's still a bunch of work around cost optimization in the factory after we launch with ramp inefficiencies, and we need to work those costs down. And then there will be work to land on what the right mix is within the country and where we ultimately land on the product offering. So I think just for now, it's safe to assume that it's roughly in line with the margins that you see coming out of the Fremont facility.

George M. Dailey - *Morgan Stanley, Research Division - Research Associate*

Great. And if I could just sneak in one more. So it's been over 7 years since you launched the Model S, and many OEMs seem that they don't have the same commitment to battery electric vehicles that you do, and many don't even offer one right now. As your business model proves to be more

sustainable, could we potentially see Tesla maybe supplying other OEMs with batteries or software, complete electric vehicle architectures maybe in an effort to accelerate mass adoption of sustainable transport?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. I think there's -- it will be consistent with the mission of Tesla to help other car companies with electric vehicles on the battery and powertrain fronts, also in other fronts. So it's something we're open to. As I think a lot of people know, we open-source our patents so that those would not serve as an obstacle to the adoption of electric vehicles or solar power or stationary storage. And we're definitely open to supplying batteries and powertrains and perhaps other things to other car companies.

Operator

Our next question comes from Maynard Um with Macquarie.

Maynard Joseph Um - *Macquarie Research - Analyst*

I have 2 questions. The first is software Version 10 added a lot of functionality that's never really been available in a car before through an over-the-air update. In your shareholder letter, you say that this lays an important foundation for things to come. Can you just talk about the longer-term plan or your vision for the direction of this software platform and if you have plans to monetize that opportunity?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Well, the goal for the infotainment system is to say what's the most amount of fun you can have in a car, which I think is -- I don't think other car companies really think about it that way. But it's really what is the most fun -- how can we maximize the enjoyment in a car such that it's not some -- just some sort of transport utility device with no soul and no character. We want it to be fun and entertaining in reference to something that you love.

And so just I think there's a lot one can do because people are generally spending a couple of hours a day on average in the car. And so that's pretty high percentage of the waking time, outside of like showering and going to the bathroom and that kind of thing. It's just a lot of time. And I guess maybe there's some way to monetize it but we haven't really thought about it that way.

But our goal is just to make -- try to say what is the most fun you could possibly have while you're in your car. And obviously, as autonomy gets better and better, that is going to become much more of an entertainment opportunity. So we'll see where that leads. But that's what we're after. It's our goal.

Maynard Joseph Um - *Macquarie Research - Analyst*

Great. And then can you help us -- help frame for us the opportunity for emission credits as the standards in the EU start to tighten next year? And I'm not looking for an exact number but maybe more to understand whether this is an opportunity in the tens of millions, hundreds of millions, billions. Anything to help us frame the opportunity and also whether you have any ongoing dialogues with OEMs.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

We certainly have ongoing dialogues with OEMs. But as you see from our financials, the tax credits

or emissions credits are not forming a very big percentage of our revenue. They're -- I mean, Zach, what was the last quarter? It was really quite...

Zachary Kirkhorn - *Tesla, Inc. - CFO*

It was over \$100 million.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

But out of like several billions. So it's like 1.5%. It's not exactly a giant percentage. And obviously, those credits in the U.S. are really not -- a credit situation not particularly strong for obvious reasons, which we think is not great for the future. But anyway, that's the way it is.

In Europe, it's much more of a sensitivity to the environment. But we're not counting on some big windfall. Maybe it will be good. Maybe not. We don't know. But we're not counting on it.

Zachary Kirkhorn - *Tesla, Inc. - CFO*

Yes. I think that's a fair way to characterize it. I mean our expectation is that credit revenues will generally increase with time, not necessarily increasing every quarter. We did increase from Q2 to Q3. But there's a certain amount of them that are baseline based on the number of cars that we build and deliver. And there's others that are deal-specific, and those deals can happen at any point.

So we're constantly in conversations with automakers about this. But within the company, we manage the business without counting on any profit or cash flows from regulatory credit. And we view it as purely incremental, and my recommendation is that everyone should view it that way. It's just an extra that comes through.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

It's obviously a good thing to do that would help accelerate the advent of sustainable energy for sure. But it's -- and like I say, I think outside the U.S., there seems to be a strong push in that direction, which is great. And probably within the U.S., that over time will become a strong push.

Operator

Our next question comes from Emmanuel Rosner with Deutsche Bank.

Xin Yu - *Deutsche Bank AG, Research Division - Research Associate*

It's Edison on for Emmanuel. First, there's been a lot of activity in the industry about electric pickups lately. Just curious if you have any updates, any more insights you can share on the one that you're about to put out later.

And then secondly, there was a comment, I think, earlier about the order book quarter to date. Can you just clarify what was the baseline? And any insights about the geographic mix of that?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. We -- I think we've said enough about the Tesla side of the truck. We're not going to -- this is not the right forum for us to do product launches. But I think it'll be -- will be -- I mean, my opinion, and this could be totally wrong, it could be totally out to lunch here, but I think the Tesla side of truck is our best product ever. That's my opinion. Yes. The demand is not -- it seems to be strong. So we should be production-constrained this quarter.

Zachary Kirkhorn - *Tesla, Inc. - CFO*

Yes, that's right. The baseline from the comment earlier that I made was looking at this point in the quarter in Q2. And order rates are strong, I would say, in all markets. I think we're very encouraged as a team at the reception of our products. As more and more people become aware of electric vehicles, I think competitive products help raise that awareness, and overall interest is just increasing.

So our focus internally is to increase production as fast as we can, both with the existing equipment and accelerating our timelines on new capacity. We believe that everybody should be driving an electric car. So we need to move as quickly as we can.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes, absolutely. But we want to get the Tesla volume to where it is, perhaps somewhere on the order of 1% -- replacing 1% of the global fleet over time. That's, I think -- we think it's pretty big, but that's -- we think that's a good one to aim for, which is about 20 million vehicles a year, just by the way.

But I do think that the demand for new cars will rise as the world transitions away from combustion engine vehicles. Just as when people had CRT TVs, there's no cathode ray tube TVs, the sales rate was just basically a replacement rate. You wouldn't buy -- you wouldn't really buy a new CRT TV unless it was broke. But when flat screens came out, there was a big step-change in demand because now getting a big flat screen TV was much better than having a small CRT TV.

And I think we'll see the same thing with electric vehicles, which is that the -- it's not just people are just buying a car just because their last car wore out. They'll buy an electric car because it's a fundamentally better car, and especially if it's got self-driving.

Operator

Your next question comes from Pierre Ferragu with New Street Research.

Pierre C. Ferragu - *New Street Research LLP - Global Team Head of Technology Infrastructure*

I'd be interested to hear how yourâ

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

We can't hear you. It's very quiet so we can't hear you.

Pierre C. Ferragu - *New Street Research LLP - Global Team Head of Technology Infrastructure*

Oh can you hear me well?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

It's muffled, but we'll try.

Pierre C. Ferragu - *New Street Research LLP - Global Team Head of Technology Infrastructure*

Okay. Sorry for that. So I was wondering how your thinking has evolved on Model S and Model X. It looks like the deliveries have stayed to the levels of the previous quarter and that Model 3 has

indeed cannibalized this demand for these cars quite a big deal. So how are you thinking about these 2 models going forward? What's the strategy you have in mind? And then I have a quick follow-up on the Model Y.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

The Models S and X are really niche -- they're really niche products. I mean they're very expensive, made in low volume. To be totally frank, we'll keep -- we're continuing to make them more for sentimental reasons than anything else. They're really of minor importance to the future.

Pierre C. Ferragu - *New Street Research LLP - Global Team Head of Technology Infrastructure*

Okay. That makes sense. And then my question...

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

They're a great car. Model S, I think, is by -- if you want to -- I mean Model S literally won Motor Trend's best car ever in history, by the way. I think if you're out there and you're buying -- and you're sedan-buying and you don't buy a Model S, I think you've just made a mistake, to be totally frank. It's incredible, especially the new one with variable damping, suspension, hospital operating room, HEPA filter for air purification, the Raven powertrain. It's the fastest car in the world. And it's just it's so easy to drive. It makes you feel like Superman driving that car. It's incredibly safe. It's just an amazing vehicle.

And then Model S, I think, it's like the Fabergé egg of cars -- I mean Model X. Model X is like the Fabergé egg of cars. It's -- I mean that's why so many artists and musicians buy the cars. It's an art piece, basically.

Zachary Kirkhorn - *Tesla, Inc. - CFO*

Yes. I mean it's just that. I agree. They're absolutely phenomenal cars. And we are increasing production on kind of S and X lines for this quarter in response to increasing demand. And so I think part of the story here is, as we've launched, ramped and stabilized Model 3, that consumes a lot of the attention around the company. But now that -- as that has stabilized, we're able to focus our attention and balance that between S and X and Model 3.

And so the delivery numbers in Q3 understated the interest in the product for that quarter. And we continue to see strength in the order rate, which we anticipate will be reflected in S and X deliveries in Q4.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

I mean Model S -- basically, Model S at this point has a range of 370 miles. Actually, technically, it's 373, but we actually certified it incorrectly at 370. But it's 373. And there are some software improvements that we think will make that even better.

Oh I forgot to mention, we're also expecting that there's going to be out there improvement -- that will improve the power of the Model S, X and 3. That's a by the way; this is coming in a few weeks. It should be on the order of 5% power improvement due to improved firmware. Drew, do you want to say anything on that one?

Andrew D. Baglino - *Tesla, Inc. - CTO*

Yes. We're just continuing to learn how to optimize the motor control in our products. And yes, so a

5% improvement for all 3 customers and 3% for S and X.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. And there's also the single-pedal driving that will improve the range as well.

Andrew D. Baglino - *Tesla, Inc. - CTO*

Yes. Very excited about that. It's going to -- it's an improvement in comfort and feel.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. So basically, it's easier to drive, and it improves the range.

Andrew D. Baglino - *Tesla, Inc. - CTO*

Yes. And faster supercharging.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Oh, and faster supercharging.

Andrew D. Baglino - *Tesla, Inc. - CTO*

For Standard Range and Standard Range Plus customers, which is a big deal.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. I don't think there's ever been a situation in history where you buy a car and it gets way better over time just due to software. Not a little bit better, but a lot, right? Because -- yes.

Andrew D. Baglino - *Tesla, Inc. - CTO*

It's very exciting. I think, yes, as a customer myself, I enjoy these updates. Always look forward to them.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. It might move the Model S range to almost 380 or high 370s with the update.

Unidentified Company Representative -

And we're not stopping to work there. We continue working on our developments. Yes.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes, absolutely.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Pierre, did you have a follow-up question?

Pierre C. Ferragu - *New Street Research LLP - Global Team Head of Technology Infrastructure*

Yes, yes. Just a quick one on the Model Y. So I was wondering if you -- what you've learned with the S and X makes you think maybe when you launch Model Y, you'll have some cannibalization of demand of the Model 3? And have you started to think about that and how to approach it?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

No, I don't think -- we're not expecting to see cannibalization of Model 3. One is a sedan. One is an SUV.

Zachary Kirkhorn - *Tesla, Inc. - CFO*

Yes. The best comparison we have for that is when we launched Model X and we had Model S at the time.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. Model S sales increased.

Zachary Kirkhorn - *Tesla, Inc. - CFO*

Yes. And we didn't see any cannibalization there.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

The opposite. When we launched Model X, Model S sales increased.

Zachary Kirkhorn - *Tesla, Inc. - CFO*

Yes. So that's the best comparison that we have.

Operator

Our next question comes from Dan Levy with CrÃ©dit Suisse.

Dan Meir Levy - *CrÃ©dit Suisse AG - Research Division - Director & Senior Equity Research Analyst*

First, just wanted to ask a question on the Giga 3. You're targeting 3,000 units a week. But we saw with Fremont that the ramp on Model 3 was lumpy. And you'd sort of ramp and then you sort of cut production to fix the bottlenecks. Given that this is a brand-new capacity, how smooth should we expect production to be on a week-to-week basis? Meaning once you hit the 3,000, is that 3,000 you could go every single week in a quarter? Or is it still going to be lumpy within a quarter?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

I mean if you've got a crystal ball, we'd love to use it.

Dan Meir Levy - *CrÃ©dit Suisse AG - Research Division - Director & Senior Equity Research Analyst*

I'm looking for it.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Yes. It should be smoother than Model 3 because there's a lot of commonality of parts. But -- and I think if you look over a reasonable enough time frame, the production will actually be fairly smooth. But from a week-to-week standpoint, it obviously will not be. It will be about as smooth as, say, the stock market. I mean how smooth is the stock market from one week to the next? It's -- but if you just extend the time period to, say, 2 or 3 quarters, it will be a very rapid steady ramp. And obviously, it will go way past 3,000 a week.

Dan Meir Levy - *Crédit Suisse AG - Research Division - Director & Senior Equity Research Analyst*

Okay. Great. And then just a follow-up. You mentioned -- Elon, you mentioned earlier in your comments that one of the things you're optimistic on in the future is Tesla Energy. And I think we understand the part that one of the challenges in the past was sort of a reallocation of resources away from energy to the auto side. Could you just talk to where you see the greatest pockets of growth in energy? Is it solar or storage? And now that you have to -- now that you can reallocate resources, what would that entail in terms of capacity growth? Or what does reallocation of resources look like?

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

Well, I think from a percentage basis, solar will grow the fastest, but storage will also grow high on a percentage basis. I think both, over time, will grow faster than automotive. I think it's starting from smaller base. And I think especially if you look at sort of -- if you look at like year-over-year growth, it will be absolutely incredible, I think. From one quarter to the next, there might be some fluctuations due to seasonality or some short-term part shortage or you name it, but it could be, over the course of, say, a year, gigantic increase.

Also with solar, it's hard to install a lot of solar in the winter, especially on the East Coast. The roofs are full of snow and ice. So you would expect to see some seasonality there, but then it ramps up quite a bit when -- as the weather improves. Yes.

Martin Viecha - *Tesla, Inc. - Senior Director for IR*

Okay. Thank you very much. And I think that's, unfortunately, all the time we have today. Appreciate all your questions, and we're looking forward to talking to you next quarter. Thank you very much, and goodbye.

Elon R. Musk - *Tesla, Inc. - Founder, CEO & Director*

All right. Thanks.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for your participation. You may now disconnect.

Call participants:

Corporate Participants

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Elon R. Musk, Tesla, Inc. - Founder, CEO & Director

Kunal Girotra, Tesla, Inc. - Senior Director of Energy Operations

Martin Viecha, Tesla, Inc. - Senior Director for IR
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