U.S.News & WORLD REPORT

Will the SolarCity Deal With Tesla Go Through?

The market seems to think the TSLA-SCTY merger still isn't a done deal.

By John Divine | Staff Writer Sept. 19, 2016, at 7:00 a.m.

To Tesla CEO Elon Musk, the TSLA-SCTY merger is a big picture, long-term move. (THE ASSOCIATED PRESS/GETTY IMAGES)

Stocks mentioned in this story: SCTY, TSLA, MON

On August 1, SolarCity Corp. (ticker: SCTY) agreed to be acquired by Tesla Motors Inc(TSLA) in a $2.6 billion, all-stock deal. Tesla gushed that the merger would create the "world's only integrated sustainable energy company," and the financial news media went crazy.

But less than two months later, the market is telling the world that the deal might not even go through.

Under the terms of Tesla's SolarCity acquisition, SCTY shareholders will receive 0.11 shares of TSLA stock for each share they own. Tesla's share price is about $200, which would imply a so-called takeout price of about $22 for SCTY. But SolarCity shares are far below that, trading at less than $17.

Numbers don't lie. And the numbers are awfully skeptical this deal will ever be consummated. And in fact, there are quietly a lot of reasons the sexiest M&A deal of 2016 – sorry Bayer-Monsanto Co. (MON) – could actually get held up.

First, SolarCity's ability to raise cash was directly and negatively impacted by the Tesla buyout offer, according to a filing with the Securities and Exchange Commission. This caused additional liquidity problems; an ironic consequence of Tesla's offer is that it actually made SCTY stock less valuable.

"The merger agreement tacitly encourages SolarCity to delay paying its short-term accounts payable," says Barry Randall, technology portfolio manager for Covestor. "Because once the deal closes, Tesla can repay what will then be its debts."

Tesla's own financing demands could be contributing to the seemingly high degree of market skepticism as well, according to Jerry Braakman, chief investment officer of First American Trust.

"Tesla also needs significant capital for its projects, specifically the build out of the Gigafactory, and the ramp up of Model 3 production to meet demand," Braakman says. The capital-intensive nature of both SCTY and TSLA "may mean additional leverage and equity dilution with additional share issuance."

In fact, TSLA does need to raise more money (that means either debt or dilution) by the end of the year, a fact it acknowledged in an SEC filing on Aug. 31. The electric car manufacturer already tapped the equity markets for $1.7 billion in a secondary offering in May, but apparently funding a revolutionary auto-technology-energy company hybrid isn't cheap nowadays.

Alexander Gladstone, author of a recent report on SolarCity on Debtwire, a financial news and intelligence service, attributes the large spread between the takeout price and SolarCity's current stock price to downside risk.

"There would be so much downside if for some reason something derailed" the deal, Gladstone says. He doesn't expect that to happen, though, and pegs the chances that it ultimately goes through above 50 percent.

Still, the possibility it falls through – and the devastating effect that would have on the SCTY stock price – has to be accounted for in the markets.

On top of all that, there are glaring corporate governance issues that have clouded the deal from the start. Tesla CEO Elon Musk, for example, is the largest shareholder in both companies, and his cousin, Lyndon Rive, is the CEO of SolarCity; another cousin, Peter Rive, is a board member. Two other SCTY board members are either on Tesla's board or in the C-suite.

Those are just the conflicts of interest on the SolarCity board. Tesla's board is also teeming with them, and it includes Musk's own brother. To be fair, the deal's acceptance will be contingent upon "the approval of a majority of disinterested shareholders" of each company, meaning that the brothers Musk and Rive will recuse themselves.

Still, it's hard to imagine that the overlapping movers and shakers at each company won't have some influence in ushering the deal through.

But let's say they don't. What if the deal doesn't, in fact, go through? Wall Street wouldn't be discounting SCTY stock so severely if this weren't a real possibility. So what would that look like for shareholders?

Well, for SCTY shareholders, this would be an obvious negative. "SolarCity's operational and financial trajectory has it headed toward bankruptcy," Randall says. With SolarCity's cash burn so severe, its viability sans Tesla is very much an open question that shareholders don't want to see answered.

For TSLA, the consequences of the deal falling through are less clear.

Musk ostensibly seems to think it's the right thing to do: He sees the combined company as the world's first vertically integrated sustainable energy powerhouse, and claims there will be $150 million in synergies within the first year. He even called the fact that they weren't the same company to begin with an "accident of history."

To Musk, the SCTY merger is a big picture, long-term move.

Incidentally, not everyone believes him. Many openly chastised the offer as a not-so-subtle bailout of a company Musk is deeply involved in.

"Tesla's offer to buy SolarCity has nothing to do with supposed 'synergies' between the two companies," Randall says. He thinks the deal is "nothing more than a deeply cynical attempt to preserve Elon Musk's reputation," which Randall feels would be tarnished if SolarCity were to go bankrupt. In Randall's eyes, the perception of Musk as a brilliant businessman who can do no wrong is central to Tesla's ability to fundraise and maintain a meteoric stock valuation.

Wall Street doesn't appear to share Musk's enthusiasm for the deal either. When Tesla announced the deal its shares fell, and the company will either have to flood the market with more TSLA stock or go further in debt in order to finance the acquisition.

That's not to mention the SolarCity debt ($2.8 billion) and negative cash flows that Tesla will inherit. Some are estimating the combined company could shed up to $1 billion a quarter, Gladstone says.

The long-term upside that Musk sees in the deal isn't quite so visible to the wider market with all these glaring, immediate negatives muddying the picture.

At the end of the day, one of the highest-profile M&A deals of 2016 isn't quite the surefire bet it was just a few months ago. What's clear as crystal is that SCTY needs the deal to happen. What's not so clear is whether Tesla will ultimately benefit if it does.

What would happen to TSLA if the deal is vetoed?

"You would expect to see Tesla stock shoot up," Gladstone says. "Tesla would spike."

Alternative Energy Stocks

SolarCity Corp. has been one of the worst-performing alternative energy stocks on Wall Street this year.

Stock Name	Market Cap	YTD Return
Ormat Technologies Inc ORA	$2.4B	32.03%
NextEra Energy Partners LP NEP	$1.2B	5.16%
Pattern Energy Group Inc PEGI	$1.7B	10.95%
Atlantica Yield PLC ABY	$1.9B	3.11%
Covanta Holding Corp CVA	$1.9B	3.16%
Calpine Corp CPN	$4.7B	9.33%
TerraForm Power Inc TERP	$1.1B	4.53%
Sky Solar Hldgs Shs Sponsored American Deposit Receipt Repr 8 Shs SKYS	$144.8M	60.13%
TerraForm Global Inc GLBL	$407.4M	37.57%
SolarCity Corp SCTY	$1.7B	66.48%

Stock information as of September 16th, 2016

See More Alternative Energy Stocks