The Impact Of A Federal Investigation And Lawsuits On SolarCity's Stock Price

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Summary

- The U.S. Treasury Department Inspector General has been investigating SolarCity for its use of "fair market value" pricing on leased systems. The findings of this investigation can be released at any time.
- Two class action lawsuits that were filed after SolarCity revealed it had accounting errors in its financial statements are still pending. The outcome may hurt the stock price.
- Two additional class action lawsuits were filed by hourly employees and Field Energy Advisors for overtime pay. If found true, shrinking profit margins may be the cause.
- SolarCity keeps borrowing in increasingly larger amounts. It recently issued a third securitization for $201 million. Previously, it borrowed $54.4 million and $70.2 million. The Silevo project will cost $750 million.

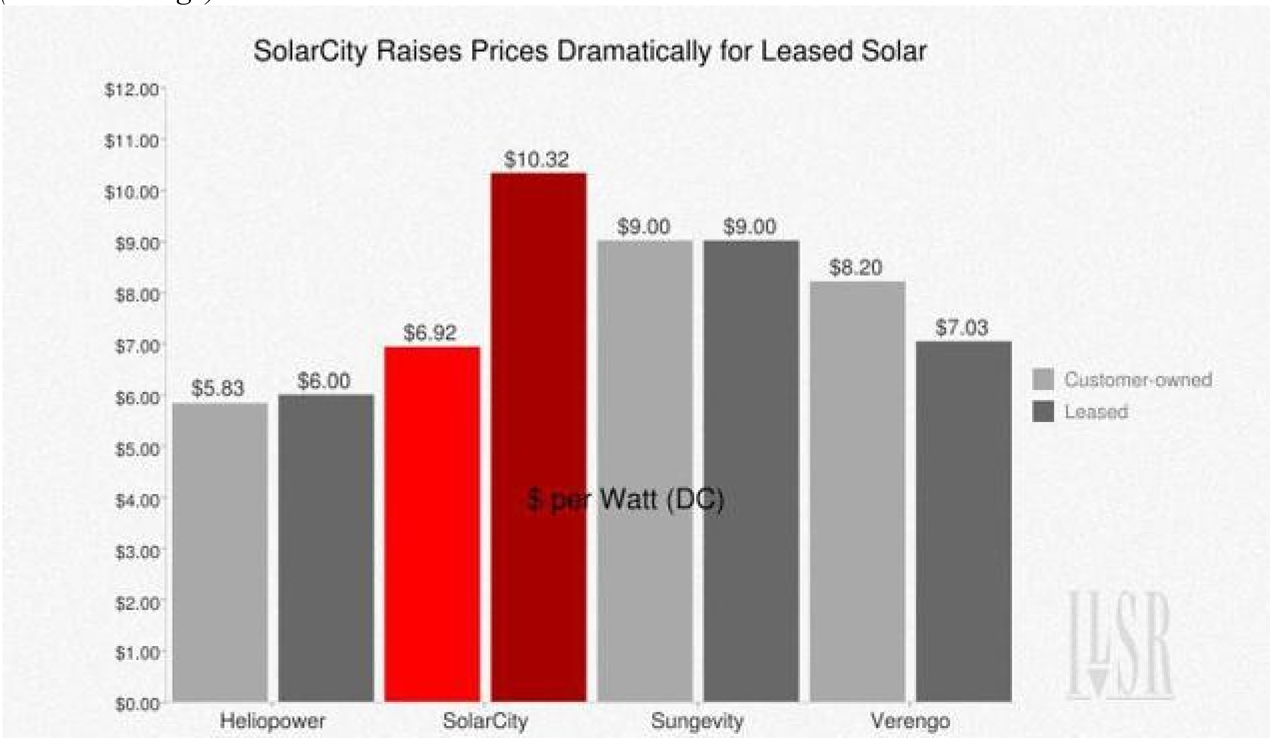
Federal Investigation Against SolarCity

The ongoing Federal investigation's charges against SolarCity (NASDAQ:SCTY) and others are partially based on data from University of Colorado economics doctoral candidate Molly Podolefsky. Her thought-provoking paper entitled: *Tax Evasion and Subsidy Pass-Through Under the Solar Investment Tax Credit* is definitely worth a read.

Ms. Podolefsky finds "the prices firms report for third-party systems exceed prices of customer-owned systems by 10 percent, or $3,900 per system." Based on her in-depth study, she concluded that "third-party PV firms in California were awarded $25 million in excess ITC (investment tax credit) tax benefits due to price over-reporting between 2007 and 2011."

The below chart from ILSR demonstrates the average installed cost of leased and owned residential systems of four competing solar companies in California. The companies are HelioPower, SolarCity, Sungevity, and Verengo. This 2010 data is from the California Solar Initiative for smaller-than-10 kW residential solar PV projects in the Southern California Edison territory.

(click to enlarge)



SolarCity has responded to above findings by Ms. Podolefsky and the similar charges made by Barrons against it by stating this in its blog: "... in applying for Section 1603 grants, we have relied on independent appraisers using well established IRS guidelines, and all of our projects were valued at or below the guidance that Treasury itself had published for the industry beginning in June 2011."

I don't know if you have gone through the process of having a house appraised, but if you have, you already know that appraisers can be very conservative or extremely aggressive on how they price things. For SolarCity to shift responsibility of price over-reporting claims to an independent appraiser is simply not adequate nor convincing.

The Federal investigation started in October of 2012. I would be shocked if after nearly two years of investigation, which includes cooperation between the Treasury and the Justice Department, the Feds report back that they have wasted taxpayer money and they have zilch to show for it. It is far more likely that they have lots of evidence and are building a strong case against SolarCity on how to recover taxpayer funds.

That possibility did not miss SolarCity. Here is what SolarCity stated in its 2012 annual report with regard to the above noted investigation: "If at the conclusion of the investigation the Inspector General concludes that misrepresentations were made, the Department of Justice could decide to bring a civil action to recover amounts it believes were improperly paid to us … we could then be required to pay damages and penalties for any funds received based on such misrepresentations."

If SolarCity is found guilty of misrepresentation, the really bad news for SolarCity wouldn't be the funds it would have to raise to pay back the amounts owed; it's the potential hit its brand may take for essentially defrauding taxpayers. Let's look back at the letter Senator Jeff Sessions, a ranking member on the Committee of Budget, wrote to Treasury Secretary Jack Lew:

"The financial pressures related to a private company's survival should not cause the federal government to modify its policies or place additional taxpayer money at risk… There is concern that SolarCity might become the next Solyndra - a company propped on the back of the taxpayers."

Solyndra was an alternative energy manufacturer of cylindrical panels of copper indium gallium selenide based in Fremont, California, that in September of 2011, ceased all operations, filed a chapter 11 bankruptcy, and laid off all employees.

If this Federal investigation finds SolarCity to be guilty, the stock price may be adversely affected for many years to come.

Two Class Action Lawsuits Filed Against SolarCity for Revealing Financial Statement "Errors"

1) On April 7th, 2014, The Shareholders Foundation filed a lawsuit against SolarCity on behalf of some of the company's shareholders who allege the company is in violation of Federal Securities laws. Specifically, the lawsuit is focusing on the company's announcement on March 18, 2014 that previous financial statements should no longer be relied upon. As captured from the filing, "The plaintiff claims that the defendants made allegedly false and/or misleading statements and/or failed to disclose that SolarCity Corp lacked adequate controls over financial reporting, that SolarCity Corp misclassified its reported expenses, that... SolarCity Corp's financial statements were materially false and misleading at all relevant times." Lyndon R. Rive, CEO, and Robert D. Kelley, CFO, were also named as defendants in the lawsuit.

2) On April 22nd, 2014, Law Offices of Howard G. Smith announced that a class action lawsuit has been filed in the United States District Court for the Northern District of California on behalf of all purchasers of the securities of SolarCity Corporation between March 6, 2013 and March 18, 2014.

The Complaint alleges that throughout the Class Period defendants incorrectly accounted for expenses associated with the Company's larger Sales segment, and failed to properly allocate such expenses between the Sales and Leasing segments. The Complaint further alleges that the Company was under pressure from investors to demonstrate the strength of its solar energy operations, and improperly allocated expenses between its two reporting segments in order to hide the Sales segment's ballooning expenses and inflate its reported gross margins.

Even if we were to completely ignore the above claims, the way SolarCity uses "Retained Value" is already out of bounds, in my view. Its metrics use a couple of assumptions that I find completely unreasonable.

Firstly, SolarCity assumes at least 90% of all clients will essentially continue paying it for another 10 years, after the initial 20-year lease expires. That seems highly unlikely, as we don't know what the demand of solar will be, nor do we know what competing alternative energy solutions, like hydrogen, or new technologies will do that far out into the future.

In addition, SolarCity uses backlog data in its "Retained Value" reporting, yet it stopped releasing its cancellation numbers in May of 2013. Whenever there is even a hint of possible accounting shenanigans, investors should be concerned and extremely cautious.

Two Additional Class Action Lawsuits Filed by Hourly Employees and Field Energy Advisors For Overtime Pay

Hourly employees and Field Energy Advisors have filed two separate class action lawsuits for essentially overtime pay violations. In the latter case, Field Energy Advisors were classified as exempt, when they allegedly should have been classified as non-exempt. Had they been classified as non-exempt, they would eligible for overtime pay, as well as meal break wages.

The complaint, which was filed by the law firm of Blumenthal, Nordrehaug & Bhowmik, alleges that the Field Energy Advisors mostly engaged in non-exempt tasks throughout their workday, including setting up promotional tables in big box retail stores across California in order to qualify leads using pre-formatted templates provided to them by SolarCity. The complaint asserts that as a result of the finite set of job tasks that the Field Energy Advisors were required to do on a daily basis, these employees should have allegedly been paid overtime pay for their hours worked in excess of eight in a workday, and hours worked in excess of forty in any workweek.

Most such lawsuits typically get settled before they go to trial. However, just the filing of such lawsuits should raise red flags for investors. What if they are true? Are profit margins so tight that it is cutting corners with its employees' fair wages? SolarCity keeps borrowing more money, so these types of concerns are well warranted.

SolarCity Subsidiaries Filed a Lawsuit Against The Federal Government for $14.6 million!

In a shocking twist, in 2013, two SolarCity, Inc. subsidiaries that share office space with SolarCity had filed a $14.6 million lawsuit against the Federal government claiming: "The Treasury has failed to pay Plaintiffs cash grants in the amounts that they are entitled to, thereby materially frustrating congressional intent." Yes, you read that correctly. They are actually biting the hand that feeds them. In fact, SolarCity has received over $422 million in Federal tax incentives already. Is it in that tough of a financial bind that it resorts to filing a measly $14.6 million lawsuit against the Feds?

In March of 2014, a California judge gave SolarCity and the U.S. Government until December of this year to finish the discovery process. In my view, this lawsuit is a clear misstep on several levels. When there is an ongoing Federal investigation against your company for essentially over-billing, you have to be very humble and cooperative. When you file a lawsuit against those that are investigating you for over-billing, and ask for even more money, you only motivate them to be extra-vigilant in their investigation. That sort of bravado usually doesn't end well.

SolarCity Keeps Borrowing Money

One July 25, 2014, SolarCity announced it has completed a third securitization deal where it has borrowed $201 million by issuing Class A and Class B notes to BofA Merrill Lynch. In November of 2013, it had borrowed $54.4 million from Credit Suisse. In April of 2014, it had borrowed $70.2 million, once again from Credit Suisse. Not surprisingly both Credit Suisse and BofA Merrill Lynch have lofty price targets for SolarCity. As everyone knows, if there is anything negative that comes out in the August 7, 2014 earnings report, the very same analysts may reduce their price targets, and may change their ratings. Nothing is constant.

Here is how the securitization works. SolarCity essentially bundles a pool of solar systems, related leases and power-purchase agreements, then sells it to investors. Unlike mortgages, there is no insurance for this type of transaction. If investors don't get their money back, specifically the Class A notes, it would allow investors to go after the underlying assets that SolarCity used to secure the notes. The economy would not take a hit in that scenario, but SolarCity and its investors probably will. As noted in my previous article, the Silevo project will take 2 years to complete. It will require an additional 3,300 employees, and is projected to cost $750 million. The money it has borrowed thus far is nowhere near what it needs.

Conclusion

There are lots of challenges facing SolarCity, and all of those challenges may negatively impact the stock price. The company is unprofitable, and won't be profitable even next year. It is going through a Federal investigation. It has several lawsuits to contend with, yet it is piling up massive amounts of debt. It has tough competitors, including First Solar (NASDAQ:FSLR), SunPower Corporation (NASDAQ:SPWR), and others. All of this during a time when residential Federal tax credits for having solar-electric systems will be slashed to 10% from 30%, and SolarCity's imported panels from China will be facing tariffs.

During these challenging times, SolarCity is aggressively expanding into a 2-year Silevo project, with an ultimate price tag that is nearly double the amount of every penny in total revenue it has reported since 2010.

In the long term, the crux of its plan to profitability hinges around selling 20-year solar panel leases, which locks homeowners into outdated technology almost as soon as they sign the lease. New solar technology will be developed, but homeowners that opted to take the lease option are locked into a 20-year lease. Some of those leases have already been bundled and sold to lenders like BofA Merrill Lynch and Credit Suisse. Its solar panel lease initiative is tantamount to making lease payments for 20 years on a brick cell phone, when everyone else in the modern world has a shiny iPhone, BlackBerry, Windows, or Android phone. If it were a 2-year lease, that may work, but a 20-year lease is far too long. Imagine using the same mobile phone for two decades. In my view, the lengthy lease model is fundamentally flawed, which doesn't bode well for the future of the stock price.

In the short term, I am of the opinion the current stock price, which is at $74.05 as of the writing of this article, cannot stand. In my view, it will likely go through a significant pullback by early next month, before or near its August 7th, 2014 earnings report. In addition to the above noted issues, my opinion is further supported by the fact that even though certain analysts actually raised price targets, not only did CEO Lyndon Rive and other executives like Seth Weissman recently sell large portions of their shares, but so did board member John Fisher. In fact, Mr. Fisher had disposed of over 1,500,000 SolarCity shares in July of 2014. When management sell shares so close to an earnings report, investors should be extremely cautious. The above is why I am short SolarCity.

Disclosure: The author is short SCTY. The author wrote this article themselves, and it expresses their own opinions. The author is not receiving compensation for it (other than from Seeking Alpha). The author has no business relationship with any company whose stock is mentioned in this article.