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Elon Musk's Solar Vision, Up for a Dicey Vote

Deal Professor

By STEVEN DAVIDOFF SOLOMON SEPT. 6, 2016

Tesla Motors' proposed acquisition of SolarCity is most likely to come down to whether shareholders support Elon Musk in his vision of creating a solar power juggernaut. Yet the deal also raises broader issues of how and when shareholders should vote to approve acquisitions.

Tesla's offer has been met with jeers on Wall Street. In an age when companies are spinning off businesses left and right to narrow their focus, the merger offer was a jarring counternarrative. Instead of focusing on a singular business, this would be a solar conglomerate.

SolarCity is struggling, and it needs hundreds of millions in dollars in cash. Its biggest shareholder is also Mr. Musk, who happens to be Tesla's chief executive, founder and biggest shareholder. In this light, it was hard not to see this as a bailout by Mr. Musk of his own investment.

On the other hand, Mr. Musk has successfully created two different, highly innovative businesses, Tesla and SpaceX, while actually having the idea for SolarCity, which he gave to his cousin, who helped found the business. For Mr. Musk and the shareholders who invested in his vision, this is a no-brainer, creating a one-stop shop for solar power. Not only that, but Mr. Musk seems keen on improving SolarCity's product. In the conference call after the deal announcement, he repeatedly emphasized making the panels more "attractive" so that they would improve a home's value.

The question now is whether Tesla's shareholders will continue to buy into Mr. Musk's vision and vote for the deal.

And Mr. Musk will be watching these proceedings from the sidelines: Tesla has said that the vote should be approved by a majority of the shareholders of Tesla other than Mr. Musk and his affiliates.

This means that the Tesla shareholders who are rarely heard from will have the most important voice of all on whether the acquisition is approved.

Shareholders can be finicky in exercising their franchise. But the Tesla deal shows the importance of having all buyers of significant assets hold a vote.

In other countries, a vote for a buyer of significant assets is the norm and is legally required. The reason is simple. Buyers can lose their heads, overpaying in the heat of the moment. A shareholder vote serves as a check on this behavior, ensuring that the buyer pays more attention to market indexes. The downside of this is that the buyer loses nimbleness and is at the mercy of a sometimes fickle market.

It's not always the case here. In the United States, a buyer can typically avoid a vote so long as one is not set off by the stock exchange rules. These rules require a vote only if a company issues more than 20 percent of its outstanding stock or issues stock to acquire another company in which its officers and directors have more than a 5 percent interest.

So who are the non-Musk Tesla shareholders? According to S&P Global Market Intelligence, mutual funds and other institutions own about 63 percent of Tesla's shares, and retail shareholders hold 15 percent. Mr. Musk has about 21 percent.

The institutions will drive the vote, and they will be led by Fidelity, which owns 8.9 percent, Baillie Gifford & Company, with 8.8 percent, and T. Rowe Price, with 7 percent.

These are the usual suspects in a shareholder vote. Yet their decision making is often opaque. In years past, the mutual fund industry was heavily dependent on Institutional Shareholder Services and other proxy advisory firms for recommendations on how to vote in mergers and acquisitions.

I.S.S. is the big kahuna. Research shows that a negative recommendation on a merger from the advisory firm will shift the vote as much as 20 percent.

That's a big number. But the question of how I.S.S. reaches its decisions has been in the public eye. The adviser issues a report and meets with all sides. Ultimately, I.S.S. will say that it reflects its clients' wishes and, presumably, canvasses them.

Under Chris Cernich, who, according to Reuters, recently left the firm, I.S.S. did a remarkable job of covering all public merger situations with a record and metrics, looking at whether the deal would increase value as a touchstone.

In Tesla's case, I.S.S.'s focus will most likely be on strategic fit, along with the liquidity and solvency risks. In other words, does Tesla have a need for cash in the near term that is more urgent than propping up a solar company for a long-term strategy? Ultimately, since I.S.S. is client-driven, the biggest factor may be whether big investors oppose the deal.

In this respect, I.S.S. serves as a consolidator of opinion, funneling and acting as an intermediary.

But that model is increasingly fractured. The big mutual funds have significantly expanded their internal teams to analyze merger situations. These funds still rely on I.S.S., but they also have their own independent review. For those who savagely criticize I.S.S. for leading mutual funds in groupthink, I suspect this alternative might not be the best development.

Instead of trekking to I.S.S. to make their case, now, for every shareholder vote, companies have to seek out the big mutual funds.

And how the mutual funds make their decisions is much less transparent than the proxy advisers'. No fund I know of issues a report explaining and justifying each of its votes. Moreover, the governance teams at these mutual funds deal with thousands, if not tens of thousands, of votes every year. They are not going to spend significant time on many votes, though obviously the Tesla-SolarCity merger will receive a bit more attention than most.

That means we are just not sure how these mutual funds will vote. Most funds simply vote "yes" automatically in nearly all situations. They may do so in this case.

There are also governance issues, given Mr. Musk's ownership stakes in the two companies. Some funds may decide to oppose the merger because of what they perceive as conflicts of interest rather than on the merits of the deal itself.

Then there are the retail shareholders. Many will not vote — receiving a proxy ballot in the mail and just throwing it out. But others will vote — and they will do so based on their own assumptions about Tesla being a hot stock or not. They will be more likely to follow what Jim Cramer and other retail investing figures say.

Finally, there is the wild card of hedge fund arbitrageurs. A "no" vote on the Tesla deal will probably result in a pop in the stock price. And that will mean a quick profit. This will draw in those with incentives to vote "no" on the deal to try to grab that profit. How many will pile in? That remains to be seen as this deal wends its way through the process.

But if a smart arbitrageur comes in with a theory for ending this deal and fixing the perceived governance deficits, then there is a path to defeat — one that pushes up Tesla's stock price. We saw something like this when Paulson & Company became involved with Mylan as it pursued Perrigo. You need a credible party to carry out this strategy.

All of this highlights the often arbitrary and mysterious nature of shareholder voting on takeovers. Here is a vote that will determine the course of Mr. Musk's empire, yet we are in the dark about the deliberations of the shareholders casting their votes.

It's a nice commentary on the pros and cons of today's shareholder democracy. And we'll see if these divergent shareholders are willing to challenge the vision and daring of Mr. Musk himself.

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