
**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2016

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 001-34756

Tesla Motors, Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

91-2197729
(I.R.S. Employer
Identification No.)

3500 Deer Creek Road
Palo Alto, California
(Address of principal executive offices)

94304
(Zip Code)

(650) 681-5000
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 ("Exchange Act") during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act:

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of July 29, 2016, there were 148,692,605 shares of the registrant's Common Stock outstanding.

TESLA MOTORS, INC.
FORM 10-Q FOR THE QUARTER ENDED JUNE 30, 2016

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Forward-Looking Statements

The discussions in this Quarterly Report on Form 10-Q contain forward-looking statements reflecting our current expectations that involve risks and uncertainties. These forward-looking statements include, but are not limited to, statements concerning our strategy, future operations, future financial position, future revenues, future profitability, future delivery of automobiles, projected costs, expectations regarding demand and acceptance for our technologies, future acquisitions, growth opportunities and trends in the market in which we operate, prospects, plans and objectives of management and the statements made below under the heading "Management Opportunities, Challenges and Risks." The words "anticipates", "believes", "could", "estimates", "expects", "intends", "may", "might", "plans", "projects", "will", "would" and similar expressions are intended to identify forward-looking statements, although not all forward-looking statements contain these identifying words. We may not actually achieve the plans, intentions or expectations disclosed in our forward-looking statements and you should not place undue reliance on our forward-looking statements. Actual results or events could differ materially from the plans, intentions and expectations disclosed in the forward-looking statements that we make. These forward-looking statements involve risks and uncertainties that could cause our actual results to differ materially from those in the forward-looking statements, including, without limitation, the risks set forth in Part II, Item 1A, "Risk Factors" in this Quarterly Report on Form 10-Q and in our other filings with the Securities and Exchange Commission. We do not assume any obligation to update any forward-looking statements.

PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

Tesla Motors, Inc.
Consolidated Balance Sheets
(in thousands)
(unaudited)

	June 30, 2016	December 31, 2015
Assets		
Current assets		
Cash and cash equivalents	\$ 3,246,301	\$ 1,196,908
Restricted cash and marketable securities	24,525	22,628
Accounts receivable	178,594	168,965
Inventory	1,609,607	1,277,838
Prepaid expenses and other current assets	144,678	115,667
Total current assets	<u>5,203,705</u>	<u>2,782,006</u>
Operating lease vehicles, net	2,533,726	1,791,403
Property, plant and equipment, net	3,993,250	3,403,334
Restricted cash	71,621	31,522
Other assets	66,650	59,674
Total assets	<u>\$ 11,868,952</u>	<u>\$ 8,067,939</u>
Liabilities and Stockholders' Equity		
Current liabilities		
Accounts payable	\$ 1,114,878	\$ 916,148
Accrued liabilities	558,212	422,798
Deferred revenue	558,816	423,961
Resale value guarantees	227,838	136,831
Customer deposits	679,834	283,370
Current portion of long-term debt and capital leases	626,826	627,927
Total current liabilities	<u>3,766,404</u>	<u>2,811,035</u>
Long-term debt and capital leases	2,620,002	2,021,093
Deferred revenue	533,253	446,105
Resale value guarantees	1,779,509	1,293,741
Other long-term liabilities	612,344	364,976
Total liabilities	<u>9,311,512</u>	<u>6,936,950</u>
Commitments and contingencies (Note 10)		
Convertible senior notes (Notes 8)	37,146	47,285
Stockholders' equity:		
Preferred stock; \$0.001 par value; 100,000 shares authorized; no shares issued and outstanding	—	—
Common stock; \$0.001 par value; 2,000,000 shares authorized as of June 30, 2016 and December 31, 2015; 148,015 and 131,425 shares issued and outstanding as of June 30, 2016 and December 31, 2015	148	131
Additional paid-in capital	5,383,731	3,409,452
Accumulated other comprehensive income (loss)	34,193	(3,556)
Accumulated deficit	<u>(2,897,778)</u>	<u>(2,322,323)</u>
Total stockholders' equity	<u>2,520,294</u>	<u>1,083,704</u>
Total liabilities and stockholders' equity	<u>\$ 11,868,952</u>	<u>\$ 8,067,939</u>

The accompanying notes are an integral part of these consolidated financial statements.

Tesla Motors, Inc.
Consolidated Statements of Operations
(in thousands, except per share data)
(Unaudited)

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2016</u>	<u>2015</u>	<u>2016</u>	<u>2015</u>
Revenues				
Automotive	\$ 1,181,852	\$ 878,090	\$ 2,207,916	\$ 1,771,410
Services and other	88,165	76,886	209,149	123,446
Total revenues	1,270,017	954,976	2,417,065	1,894,856
Cost of revenues				
Automotive	909,282	666,386	1,688,598	1,298,131
Services and other	85,959	75,220	201,223	123,282
Total cost of revenues	995,241	741,606	1,889,821	1,421,413
Gross profit	274,776	213,370	527,244	473,443
Operating expenses				
Research and development	191,664	181,712	374,146	348,866
Selling, general and administrative	321,152	201,846	639,362	397,211
Total operating expenses	512,816	383,558	1,013,508	746,077
Loss from operations	(238,040)	(170,188)	(486,264)	(272,634)
Interest income	2,242	247	3,493	431
Interest expense	(46,368)	(24,352)	(86,993)	(50,926)
Other income (expense), net	(7,373)	13,233	1,804	(9,072)
Loss before income taxes	(289,539)	(181,060)	(567,960)	(332,201)
Provision for income taxes	3,649	3,167	7,495	6,207
Net loss	\$ (293,188)	\$ (184,227)	\$ (575,455)	\$ (338,408)
Net loss per share of common stock, basic and diluted	\$ (2.09)	\$ (1.45)	\$ (4.22)	\$ (2.68)
Weighted average shares used in computing net loss per share of common stock, basic and diluted	139,983	126,689	136,330	126,320

The accompanying notes are an integral part of these consolidated financial statements.

Tesla Motors, Inc.
Consolidated Statements of Comprehensive Loss
(in thousands)
(Unaudited)

	<u>Three Months Ended June 30,</u>		<u>Six Months Ended June 30,</u>	
	<u>2016</u>	<u>2015</u>	<u>2016</u>	<u>2015</u>
Net loss	\$ (293,188)	\$ (184,227)	\$ (575,455)	\$ (338,408)
Other comprehensive income (loss):				
Unrealized net gain on derivatives and short-term marketable securities, net of tax	22,928	4	43,733	208
Foreign currency translation adjustment	(2,300)	1,157	(5,984)	(14,990)
Other comprehensive income (loss)	20,628	1,161	37,749	(14,782)
Comprehensive loss	<u>\$ (272,560)</u>	<u>\$ (183,066)</u>	<u>\$ (537,706)</u>	<u>\$ (353,190)</u>

The accompanying notes are an integral part of these consolidated financial statements.

Tesla Motors, Inc.
Consolidated Statements of Cash Flows
(in thousands)
(Unaudited)

	Six Months Ended June 30,	
	2016	2015
Cash Flows From Operating Activities		
Net loss	\$ (575,455)	\$ (338,408)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	339,692	168,501
Stock-based compensation	156,969	86,361
Amortization of discount on convertible debt	41,696	33,712
Inventory write-downs	29,725	15,950
Disposal of property and equipment	11,563	4,991
Non-cash interest and other operating activities	16,167	6,048
Foreign currency transaction (gain) loss	(8,081)	16,771
Changes in operating assets and liabilities, net of impact of business acquisition		
Accounts receivable	(1,426)	62,832
Inventories and operating lease vehicles	(1,217,931)	(706,220)
Prepaid expenses and other current assets	19,494	(3,385)
Other assets	(7,447)	(8,355)
Accounts payable and accrued liabilities	212,949	61,261
Deferred revenue	165,144	116,812
Customer deposits	398,555	19,573
Resale value guarantee	253,710	143,216
Other long-term liabilities	65,407	29,030
Net cash used in operating activities	<u>(99,269)</u>	<u>(291,310)</u>
Cash Flows From Investing Activities		
Purchases of property and equipment excluding capital leases, net of sales	(511,579)	(831,225)
Maturities of short-term marketable securities	16,667	-
Business acquisition	-	(12,260)
Increase in other restricted cash	(58,761)	(11,696)
Net cash used in investing activities	<u>(553,673)</u>	<u>(855,181)</u>
Cash Flows From Financing Activities		
Proceeds from issuance of common stock in public offerings	1,701,734	-
Proceeds from issuance of convertible and other debt	1,108,000	168,246
Repayments of other debt	(578,683)	-
Collateralized lease borrowing	384,525	196,535
Proceeds from exercise of stock options and other stock issuances	110,478	58,871
Principal payments on capital leases	(18,270)	(13,901)
Common stock and debt issuance costs	(15,765)	(5,244)
Net cash provided by financing activities	<u>2,692,019</u>	<u>404,507</u>
Effect of exchange rate changes on cash and cash equivalents	10,316	(13,056)
Net increase (decrease) in cash and cash equivalents	2,049,393	(755,040)
Cash and cash equivalents at beginning of period	1,196,908	1,905,713
Cash and cash equivalents at end of period	<u>\$ 3,246,301</u>	<u>\$ 1,150,673</u>
Supplemental noncash investing activities		
Acquisition of property and equipment included in accounts payable and accrued liabilities	324,982	265,970
Additionally estimated fair value of facilities under build-to-suit lease	172,770	40,468

The accompanying notes are an integral part of these consolidated financial statements.

Tesla Motors, Inc.
Notes to Consolidated Financial Statements
(Unaudited)

Note 1 - Overview of the Company

Tesla Motors, Inc. (Tesla, we, us or our) was incorporated in the state of Delaware on July 1, 2003. We design, develop, manufacture and sell high-performance fully electric vehicles and energy products. We have wholly-owned subsidiaries in North America, Europe and Asia. The primary purpose of these subsidiaries is to market, manufacture, sell and/or service our vehicles and energy products.

Note 2 - Summary of Significant Accounting Policies

Public Offerings

In May 2016, we completed a public offering of common stock and sold a total of 7,915,004 shares of our common stock for total cash proceeds of approximately \$1.7 billion, net of underwriting discounts and offering costs.

Acquisition

On July 31, 2016, we entered into a definitive agreement to acquire SolarCity Corporation, which designs, finances and installs solar power systems. Pursuant to the definitive agreement, each issued and outstanding share of the common stock of SolarCity would be converted into the right to receive 0.110 (the Exchange Ratio) shares of Tesla common stock. SolarCity options and restricted stock unit awards would be converted into corresponding equity awards in respect of Tesla common stock based on the Exchange Ratio, with the awards retaining the same vesting and other terms and conditions as in effect immediately prior to consummation of the Merger. This acquisition is subject to various closing conditions, including the receipt of the affirmative vote from each company of a majority of non-interested stockholders voting at a meeting of stockholders and certain regulatory approvals.

Basis of Consolidation

The consolidated financial statements include the accounts of Tesla and its wholly-owned subsidiaries. Intercompany balances and transactions between consolidated entities have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent liabilities and accompanying notes. Estimates are used for, but not limited to, determining the selling price of products and services in multiple element revenue arrangements and determining the amortization period of these elements, residual value of operating lease vehicles, inventory valuation, warranties, fair value of financial instruments, depreciable lives of property and equipment, inputs used to value stock-based compensation including volatility, expected terms of stock option awards and forfeiture rates, income taxes, and contingencies. Actual results could differ from those estimates.

Unaudited Interim Financial Statements

The accompanying consolidated balance sheet as of June 30, 2016, the consolidated statements of operations and consolidated statements of comprehensive loss for the three and six months ended June 30, 2016 and 2015 and the consolidated statements of cash flows for the six months ended June 30, 2016 and 2015, and other information disclosed in the related notes are unaudited. The consolidated balance sheet as of December 31, 2015, was derived from our audited consolidated financial statements at that date. The accompanying consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes contained in our Form 10-K for the year ended December 31, 2015, filed with the Securities and Exchange Commission.

The accompanying interim consolidated financial statements and related disclosures have been prepared on the same basis as the annual consolidated financial statements and, in the opinion of management, reflect all adjustments, which include only normal recurring adjustments necessary for a fair statement of the results of operations for the periods presented. The consolidated results of operations for any interim period are not necessarily indicative of the results to be expected for the full year or for any other future year or interim period.

Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board issued an accounting update which amends the existing accounting standards for revenue recognition. The new guidance provides a new model to determine when and over what period revenue is recognized. Under this new model, revenue is recognized as goods or services are delivered in an amount that reflects the consideration we expect to collect. In March 2016, the FASB issued an ASU, *Revenue from Contracts with Customers: Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*, which clarifies the principal versus agent guidance in the new revenue recognition standard. In April 2016, the FASB issued an ASU, *Revenue from Contracts with Customers: Identifying Performance Obligations and Licensing*, which clarifies the guidance on accounting for licenses of intellectual property and identifying performance obligations in the new revenue recognition standard. In May 2016, the FASB issued an ASU, *Revenue from Contracts with Customers: Narrow-Scope Improvements and Practical Expedient*, which clarifies the transition, collectability, noncash consideration and the presentation of sales and other similar taxes in the new revenue recognition standard. The guidance is effective for fiscal years beginning after December 15, 2017; early adoption is permitted for periods beginning after December 15, 2016. The new standard is required to be applied retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying it recognized at the date of initial application. We have not yet selected a transition method and are evaluating the impact of adopting this guidance.

In April 2015, the FASB issued new authoritative accounting guidance on simplifying the presentation of debt issuance costs, which requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. We have retrospectively adopted this standard as of March 31, 2016, and as a result, on the December 31, 2015, consolidated balance sheet we reclassified \$9.6 million as a reduction in prepaid expenses and other current assets, along with \$15.0 million reduction in other assets, with a corresponding reduction in the aggregate carrying value of the Company's long term debt liabilities. Similarly, as a result of the change in carrying value of long term debt, \$5.2 million was reclassified out of additional paid in capital and into mezzanine equity on the December 31, 2015 consolidated balance sheet.

In February 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016 - 02, *Leases (Topic 842)*. The new standard is effective for reporting periods beginning after December 15, 2018 and early adoption is permitted. The standard will require lessees to report most leases as assets and liabilities on the balance sheet, while lessor accounting will remain substantially unchanged. The standard requires a modified retrospective transition approach for existing leases, whereby the new rules will be applied to the earliest year presented. We are currently evaluating the potential impact of adopting this guidance on our consolidated financial statements.

In March 2016, the FASB issued Accounting Standards Update No. 2016-09, "Compensation — Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting" ("ASU 2016-09"). ASU 2016-09 simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. For public entities, ASU 2016-09 is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Early adoption is permitted. We are currently evaluating the potential impact of adopting this guidance on our consolidated financial statements.

Revenue Recognition

We recognize revenue for products and services when: (i) a persuasive evidence of an arrangement exists; (ii) delivery has occurred and there are no uncertainties regarding customer acceptance; (iii) pricing or fees are fixed or determinable; and (iv) collection is reasonably assured.

Vehicle sales include standard features, customer selected options and accessories, and specific other elements that meet the definition of a deliverable under multiple-element accounting guidance including free internet connectivity, free access to our Supercharger network, and free future over the air software updates. These deliverables are valued on a stand-alone basis and we recognize their revenue over our performance period, which is generally the eight-year life of the vehicle, except for internet connectivity which is over the free four year period. If we sell a deliverable separately, we use that pricing to determine its fair value; otherwise, we use our best estimated selling price by considering costs used to develop and deliver the service, third party pricing of similar options, and other information which may be available.

As of June 30, 2016, we had deferred \$55.9 million, \$66.1 million, \$42.0 million, and \$3.7 million related to the purchase of vehicle maintenance and service plans, access to our Supercharger network, internet connectivity, and future software updates, respectively. As of December 31, 2015, we had deferred \$53.6 million, \$49.5 million, \$32.4 million, and \$2.7 million related to these same performance obligations, respectively.

Resale Value Guarantees and Other Financing Programs

Vehicle sales to customers with a residual value guarantee

Through June 30, 2016, we offered resale value guarantees or similar buy-back terms to all customers who purchase vehicles and who financed their vehicle through one of our specified commercial banking partners. Subsequent to June 30, 2016, this program is available only in certain international markets. Under this program, customers have the option of selling their vehicle back to us during the guarantee period for a determined resale value. Guarantee periods generally range from 36 to 39 months. Although we receive full payment for the vehicle sales price at the time of delivery, we are required to account for these transactions as operating leases. The amount of sale proceeds equal to the residual value guarantee is deferred until the guarantee expires or is exercised. The remaining sale proceeds are deferred and recognized on a straight line basis over the stated guarantee period. The guarantee period expires at the earlier of the end of the guarantee period or the pay-off of the initial loan. We capitalize the cost of these vehicles to operating lease vehicles on our Consolidated Balance Sheets and depreciate their value, less salvage value, to cost of automotive revenue over the same period.

In cases when a customer retains ownership of a vehicle at the end of the guarantee period, the resale value guarantee liability and any remaining deferred revenue balances related to the vehicle are settled to automotive revenue and the net book value of the leased vehicle is expensed to costs of automotive revenue. In cases when customers return the vehicle back to us during the guarantee period, we purchase the vehicle from the customer in an amount equal to the resale value guarantee and settle any remaining deferred balances to automotive revenue and we reclassify the net book value of the vehicle on our balance sheet to pre-owned vehicle inventory. As of June 30, 2016 and December 31, 2015, \$227.8 million and \$136.8 million of the guarantees were exercisable by customers within the next twelve months.

Vehicle sales to leasing partners with a residual value guarantee

We also offer residual value guarantees in connection with automobile sales to certain bank leasing partners. As we have guaranteed the value of these vehicles and as the vehicles are leased to end-customers, we account for these transactions as interest bearing collateralized borrowings as required under *ASC 840 - Leases*. Under this program, cash is received for the full price of the vehicle and is recorded within resale value guarantees for the long-term portion and deferred revenue for the current portion. We accrete the deferred revenue amount to automotive revenue on a straight line basis over the guarantee period and accrue interest expense based on our borrowing rate. We capitalize vehicles under this program to operating lease vehicles on our Consolidated Balance Sheets and we record depreciation from these vehicles to cost of automotive revenues during the period the vehicle is under a lease arrangement. Cash received for these vehicles, net of revenue recognized during the period, is classified as collateralized lease borrowings within cash flows from financing activities in our Consolidated Statements of Cash Flows.

At the end of the lease term, we settle our liability in cash by either purchasing the vehicle from the leasing partner for the residual value guarantee amount, or paying a shortfall to the guarantee amount the leasing partner may realize on the sale of the vehicle. Any remaining balances within deferred revenue and resale value guarantee will be settled to automotive revenue. In cases where the bank retains ownership of the vehicle after the end of our guarantee period, we expense the net value of the leased vehicle to costs of automotive revenue. The maximum cash we could be required to pay under this program, should we decide to repurchase all vehicles is \$597.7 million at June 30, 2016.

As of June 30, 2016 and December 31, 2015, we had \$851.9 million and \$527.5 million of such borrowings recorded in resale value guarantees and \$210.5 million and \$120.5 million recorded in deferred revenue liability, respectively.

On a quarterly basis, we assess the estimated market values of vehicles under our resale value guarantee program to determine if we have sustained a loss on any of these contracts. As we accumulate more data related to the resale values of our vehicles or as market conditions change, there may be material changes to their estimated values.

Account activity related to our resale value guarantee and similar programs consisted of the following for the periods presented (in thousands):

	Three Months Ended June 30, 2016	Six Months Ended June 30, 2016
Operating Lease Vehicles		
Operating lease vehicles—beginning of period	\$ 1,909,310	\$ 1,556,529
Net increase in operating lease vehicles	291,036	705,017
Depreciation expense recorded in cost of automotive revenues	(57,568)	(102,386)
Additional depreciation expense recorded in cost of automotive revenues as a result of early cancellation of resale value guarantee	(2,571)	(5,657)
Increases to inventory from vehicles returned under our trade-in program	(13,626)	(26,922)
Operating lease vehicles—end of period	<u>\$ 2,126,581</u>	<u>\$ 2,126,581</u>
Deferred Revenue		
Deferred revenue—beginning of period	\$ 800,968	\$ 679,132
Net increase in deferred revenue from new vehicle deliveries and reclassification of collateralized borrowing from long-term to short-term	165,875	391,639
Amortization of deferred revenue and short-term collateralized borrowing recorded in automotive revenue	(108,852)	(206,600)
Additional revenue recorded in automotive revenue as a result of early cancellation of resale value guarantee	(3,424)	(6,420)
Recognition of deferred revenue resulting from return of vehicle under trade-in program	(2,883)	(6,067)
Deferred revenue—end of period	<u>\$ 851,684</u>	<u>\$ 851,684</u>
Resale Value Guarantee		
Resale value guarantee liability—beginning of period	\$ 1,775,498	\$ 1,430,573
Net increase in resale value guarantee	270,436	651,935
Reclassification from long-term to short-term collateralized borrowing	(23,216)	(46,042)
Additional revenue recorded in automotive revenue as a result of early cancellation of resale value guarantee	(3,318)	(5,819)
Release of resale value guarantee resulting from return of vehicle under trade-in program	(12,053)	(23,300)
Resale value guarantee liability—end of period	<u>\$ 2,007,347</u>	<u>\$ 2,007,347</u>

Vehicle Leasing Program

We offer a leasing program in the United States, Canada, the UK and Germany. Qualifying customers are permitted to lease a vehicle directly from Tesla for 36 or 48 months. At the end of the lease term, customers have the option of either returning the vehicle to us or purchasing it for a determined residual value. We account for these leasing transactions as operating leases and recognize leasing revenues over the contractual term and record the depreciation of these vehicles to cost of automotive revenues. As of June 30, 2016 and December 31, 2015, we had deferred \$42.1 million and \$25.8 million of lease-related upfront payments which will be recognized on a straight-line basis over the contractual term of the individual leases. Lease revenues are recorded in automotive revenue and were \$23.9 million and \$40.6 million for the three and six months ended June 30, 2016. Lease revenues for the three and six months ended June 30, 2015, were \$9.3 million and \$15.9 million, respectively.

Warranties

We provide a manufacturer's warranty on all new and certified pre-owned vehicles, production powertrain components and systems, and energy products we sell. We accrue a manufacturer's warranty reserve which includes our best estimate of the projected costs to repair or to replace items under warranty. These estimates are based on actual claims incurred to-date and an estimate of the nature, frequency and costs of future claims. These estimates are inherently uncertain and changes to our historical or projected warranty experience may cause material changes to our warranty reserve in the future. The portion of the warranty provision expected to be incurred within 12 months is classified as current within accrued liabilities, while the remaining amount is classified as long-term within other long-term liabilities.

Accrued warranty activity consisted of the following for the periods presented (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Accrued warranty—beginning of period	\$ 198,705	\$ 155,301	\$ 180,754	\$ 129,043
Warranty costs incurred	(24,459)	(17,287)	(40,163)	(29,073)
Net changes in liability for pre-existing warranties, including expirations and foreign exchange impact	3,250	567	6,634	11,329
Provision for warranty	38,963	26,014	69,234	53,296
Accrued warranty—end of period	\$ 216,459	\$ 164,595	\$ 216,459	\$ 164,595

Our warranty reserves do not include projected warranty costs associated with our vehicles subject to lease accounting, as costs to repair these vehicles are expensed as incurred. For the three and six months ended June 30, 2016, warranty costs incurred for vehicles subject to lease accounting were \$2.6 million and \$5.1 million, and for the three and six months ended June 30, 2015, costs were \$2.4 million and \$4.2 million. Warranty expense is recorded as a component of cost of automotive revenue.

Inventory Valuation

Inventories are stated at the lower of cost or market. Cost is computed using standard cost, which approximates actual cost on a first-in, first-out basis. We record inventory write-downs for excess or obsolete inventories based upon assumptions about current and future demand forecasts. If our inventory on hand is in excess of our future demand forecast, the excess amounts are written off.

We also review inventory to determine whether its carrying value exceeds the net amount realizable upon the ultimate sale of the inventory. This requires us to determine the estimated selling price of our vehicles less the estimated cost to convert inventory on hand into a finished product. After inventory is written-down, a new, lower-cost basis for that inventory is established and subsequent changes in facts and circumstances do not result in the restoration or increase in that newly established cost basis.

Should our estimates of future selling prices or production costs change, additional and potentially material increases to this reserve may be required. A small change in our estimates may result in a material charge to our reported financial results.

Concentration of Risk

Credit Risk

Financial instruments that potentially subject us to a concentration of credit risk consist of cash, cash equivalents, restricted cash and accounts receivable. Our cash equivalents are primarily invested in money market funds with high credit quality financial institutions in the United States. At times, these deposits and securities may be in excess of insured limits. We invest cash not required for use in operations in high credit quality securities based on our investment policy. Our investment policy provides guidelines and limits regarding credit quality, investment concentration, investment type, and maturity that we believe will provide liquidity while reducing risk of loss of capital. Our investments are currently of a short-term nature and include U.S. treasury bills.

As of June 30, 2016 and December 31, 2015, our accounts receivable were derived primarily from amounts to be received from financial institutions and leasing companies offering various financing products to our customers, sales of regulatory credits, as well as the development and sales of powertrain components and systems to automotive original equipment manufacturers (OEMs). As of June 30, 2016, we have two customers who individually account for 16% and 11% of our accounts receivable, respectively.

Supply Risk

The majority of our suppliers are currently single source suppliers, despite efforts to qualify and obtain components from multiple sources whenever feasible. The loss of any single or limited source supplier or the disruption in the supply of components from these suppliers could lead to vehicle design changes, increased costs and delays in vehicle deliveries to our customers, which could hurt our relationships with our customers and result in negative publicity, damage to our brand and a material and adverse effect on our business, prospects, financial condition and operating results.

Stock-Based Compensation

We use the fair value method of accounting for our stock options and restricted stock units (RSUs) granted to employees and our Employee Stock Purchase Plan (ESPP) to measure the cost of employee services received in exchange for the stock-based awards. The fair value of stock options and ESPP are estimated on the grant date and offering date using the Black-Scholes option-pricing model. The fair value of RSUs is measured on the grant date based on the closing fair market value of our common stock. The resulting cost is recognized over the service period, which is generally four years for stock options and RSUs and six months for the ESPP. Stock-based compensation expense is recognized on a straight-line basis, net of estimated forfeitures.

For performance-based awards, stock-based compensation expense is recognized over the expected performance achievement period of individual performance milestones when the achievement of each individual performance milestone becomes probable.

For performance-based awards with a vesting schedule based entirely on the attainment of both performance and market conditions, stock-based compensation expense is recognized for each pair of performance and market conditions over the longer of the implicit or derived service period of the performance and market conditions, beginning at the point in time that the relevant performance condition is considered probable of being met.

Derivative Financial Instruments

In November 2015, we implemented a program to hedge the foreign currency exposure risk related to certain forecasted inventory purchases denominated in Japanese yen. The derivative instruments we use are foreign currency forward contracts and are designated as cash flow hedges with maturity dates of 12 months or less. We do not enter into derivative contracts for trading or speculative purposes.

The bank counterparties in all contracts expose Tesla to credit-related losses in the event of their nonperformance. However, to mitigate that risk, Tesla only contracts with counterparties who meet the Company's minimum requirements under its counterparty risk assessment process. Tesla monitors ratings, credit spreads, and potential downgrades on at least a quarterly basis. Based on our on-going assessment of counterparty risk, the Company will adjust its exposure to various counterparties. We generally enter into master netting arrangements, which reduce credit risk by permitting net settlement of transactions with the same counterparty. However, we do not have any master netting arrangements in place with collateral features.

Comprehensive Loss

Comprehensive loss is comprised of net loss and other comprehensive income (loss). Other comprehensive income (loss) consists of unrealized gains and losses on derivatives, our available-for-sale marketable securities, and foreign currency translation adjustment that have been excluded from the determination of net loss.

Net Loss per Share of Common Stock

Our basic and diluted net loss per share of common stock is calculated by dividing net loss by the weighted-average shares of common stock outstanding for the period. Potentially dilutive shares, which are based on the number of shares underlying outstanding stock options and warrants as well as our convertible senior notes, are not included when their effect is antidilutive.

The following table presents the potential weighted common shares outstanding that were excluded from the computation of diluted net loss per share of common stock for the periods presented.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Employee share based awards	11,345,742	14,339,572	13,538,610	14,396,259
Convertible senior notes	2,345,823	2,517,573	2,150,258	2,301,823
Warrants issued May 2013	998,101	1,177,659	702,123	858,019

Since we expect to settle the principal amount of our outstanding convertible senior notes in cash, we use the treasury stock method for calculating any potential dilutive effect of the conversion spread on diluted net income per share, if applicable. The conversion spread will have a dilutive impact on diluted net income per share of common stock when the average market price of our common stock for a given period exceeds the conversion price of \$124.52, \$359.87 and \$359.87 per share for the convertible senior notes due 2018 (2018 Notes), convertible senior notes due 2019 (2019 Notes), and convertible senior notes due 2021 (2021 Notes).

Income Taxes

There are transactions that occur during the ordinary course of business for which the ultimate tax determination is uncertain. As of June 30, 2016 and December 31, 2015, the aggregate balances of our gross unrecognized tax benefits were \$119.7 million and \$99.3 million. \$115.5 million and \$95.7 million of these aggregate balances would not give rise to changes in our effective tax rate since these tax benefits would increase a deferred tax asset which is currently offset by a full valuation allowance.

Note 3 - Fair Value of Financial Instruments

The carrying values of our financial instruments including cash equivalents, marketable securities, accounts receivable, accounts payable, and accrued liabilities approximate their fair value due to their short-term nature. As a basis for determining the fair value of certain of our assets and liabilities, we follow a three-tier fair value hierarchy which prioritizes the inputs used in measuring fair value as follows: (Level I) observable inputs such as quoted prices in active markets; (Level II) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level III) unobservable inputs in which there is little or no market data which requires us to develop our own assumptions. This hierarchy requires us to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value. Our financial assets that are measured at fair value on a recurring basis consist of cash equivalents and marketable securities.

All of our cash equivalents and current restricted cash, which are comprised primarily of money market funds, are classified within Level I of the fair value hierarchy because they are valued using quoted market prices or market prices for identical securities. Our restricted short-term marketable securities are classified within Level I of the fair value hierarchy.

As of June 30, 2016 and December 31, 2015, the fair value hierarchy for our financial assets that are carried at fair value was as follows (in thousands), and unrealized gains (losses) on all financial assets for all periods presented were less than \$1.0 million:

	June 30, 2016				December 31, 2015			
	Fair Value	Level I	Level II	Level III	Fair Value	Level I	Level II	Level III
Money market funds	\$2,761,729	\$2,761,729	\$ —	\$ —	\$297,810	\$297,810	\$ —	\$ —
U.S. treasury bills	-	-	—	—	16,664	16,664	—	—
Total	<u>\$2,761,729</u>	<u>\$2,761,729</u>	<u>\$ —</u>	<u>\$ —</u>	<u>\$314,474</u>	<u>\$314,474</u>	<u>\$ —</u>	<u>\$ —</u>

As of June 30, 2016, the estimated fair value of our 2018 Notes, 2019 Notes, and 2021 Notes was \$1.09 billion (par value \$646.1 million), \$807.3 million (par value \$920.0 million), and \$1.13 billion (par value \$1.38 billion). As of December 31, 2015 the estimated fair value of our 2018 Notes, 2019 Notes, and 2021 Notes was \$1.29 billion (par value \$659.8 million), \$864.8 million (par value \$920.0 million), and \$1.27 billion (par value \$1.38 billion). These fair values represent Level II valuations. When determining the estimated fair value of our long-term debt, we used a commonly accepted valuation methodology and market-based risk measurements that are indirectly observable, such as credit risk. As of June 30, 2016, the \$678.0 million carrying value of our Credit Agreement liability approximates the fair value of the borrowings based upon the borrowing rate available to us for debt with similar terms and consideration of credit and default risk using Level II inputs.

Derivative Financial Instruments

In November 2015, we implemented a program to hedge the foreign currency exposure risk related to certain forecasted inventory purchases denominated in Japanese yen. The derivative instruments we use are foreign currency forward contracts and are designated as cash flow hedges with maturity dates of 12 months or less. We do not enter into derivative contracts for trading or speculative purposes.

We document each hedge relationship and assess its initial effectiveness at the inception of the hedge contract and we measure its ongoing effectiveness on a quarterly basis using regression analysis. During the term of an effective hedge contract, we record gains and losses within accumulated other comprehensive loss. We reclassify these gains or losses to costs of automotive sales in the period the related finished goods inventory is sold or over the depreciation period for those sales accounted for as leases. Although our contracts are considered effective hedges, we may experience small amounts of ineffectiveness due to timing differences between our actual inventory purchases and the settlement date of the related foreign currency forward contracts. Ineffectiveness related to the hedges is immaterial as of June 30, 2016.

The net notional amount of these contracts was \$212.1 million at June 30, 2016. Outstanding contracts are recognized as either assets or liabilities on the Consolidated Balance Sheet at fair value within other assets or within accrued liabilities, depending on our net position. The cumulative gain of \$51.0 million in accumulated other comprehensive income as of June 30, 2016 is expected to be recognized within cost of automotive revenue in the next twelve months. The total fair values of foreign currency contracts designated as cash flow hedges as of June 30, 2016 is \$38.3 million and was determined using Level II inputs and recorded in prepaid expenses and other current assets on our Consolidated Balance Sheets. As of June 30, 2016, \$1.3 million has been reclassified to costs of automotive sales.

Note 4 - Inventory

As of June 30, 2016 and December 31, 2015, our inventory consisted of the following (in thousands):

	June 30, 2016	December 31, 2015
Raw materials	\$ 436,953	\$ 528,935
Work in process	289,307	163,830
Finished goods	754,828	476,512
Service parts	128,519	108,561
Total	<u>\$ 1,609,607</u>	<u>\$ 1,277,838</u>

Finished goods inventory includes vehicles in transit to fulfill customer orders, new vehicles available for immediate sale at our retail and service center locations, pre-owned Tesla vehicles, and energy products.

Note 5 - Property, Plant and Equipment

As of June 30, 2016 and December 31, 2015, our property, plant and equipment consisted of the following (in thousands):

	June 30, 2016	December 31, 2015
Machinery, equipment and office furniture	\$ 1,931,100	\$ 1,694,910
Tooling	\$ 740,008	550,902
Leasehold improvements	\$ 389,154	338,392
Building and building improvements	\$ 574,603	461,303
Land	\$ 60,238	60,234
Computer equipment and software	\$ 205,926	175,512
Construction in progress	\$ 876,207	693,207
	4,777,236	3,974,460
Less: Accumulated depreciation and amortization	(783,986)	(571,126)
Total	<u>\$ 3,993,250</u>	<u>\$ 3,403,334</u>

Construction in progress is comprised primarily of tooling and equipment related to the manufacturing of Model S and Model X vehicles, Gigafactory construction, and related capitalized interest. Completed assets are transferred to their respective asset class and depreciation begins when the asset is ready for its intended use. Interest expense on outstanding debt is capitalized during the period of significant capital asset construction. Capitalized interest on construction in progress is included in property, plant and equipment, and is amortized over the life of the related assets. During the three and six months ended June 30, 2016, we capitalized \$9.9 million and \$19.0 million of interest expense. During the three and six months ended June 30, 2015, we capitalized \$12.3 million and \$20.6 million of interest expense, respectively.

We are sometimes involved in construction at our leased facilities primarily related to retail stores, service centers, and certain manufacturing facilities. In accordance with Accounting Standards Codification 840, *Leases*, for build-to-suit lease arrangements where we are involved in the construction of structural improvements prior to the commencement of the lease or take some level of construction risk, we are considered the owner of the assets and land during the construction period. Accordingly, upon commencement of our construction activities, we record a construction in progress asset and a corresponding financing liability. Once the construction is completed, if the lease meets certain “sale-leaseback” criteria, we will remove the asset and related financial obligation from the balance sheet and treat the building lease as an operating lease. If upon completion of construction, the project does not meet the “sale-leaseback” criteria, the leased property will be treated as a capital lease and included in building and building improvements in the table above. As of June 30, 2016 and December 31, 2015, the table above includes \$379.4 million and \$206.1 million of build-to-suit assets. As of June 30, 2016 and December 31, 2015, corresponding financing obligations of \$2.4 million and \$1.3 million are recorded in accrued liabilities and \$380.7 million and \$201.3 million are recorded in other long-term liabilities.

Depreciation and amortization expense during the three and six months ended June 30, 2016, was \$111.9 million and \$211.1 million. Depreciation and amortization expense during the three and six months ended June 30, 2015, was \$60.8 million and \$112.9 million. Total property and equipment assets under capital lease as of June 30, 2016 and December 31, 2015 were \$73.9 million and \$58.1 million. Accumulated depreciation related to assets under capital lease as of these dates were \$31.5 million and \$22.7 million.

We have incurred \$430.7 million of costs for our Gigafactory as of June 30, 2016.

Note 6 - Accrued Liabilities

As of June 30, 2016 and December 31, 2015, our accrued liabilities consisted of the following (in thousands):

	June 30, 2016	December 31, 2015
Taxes payable	\$ 71,985	\$ 101,206
Accrued purchases	266,592	140,540
Payroll and related costs	108,871	86,859
Warranty and other	110,764	94,193
Total	\$ 558,212	\$ 422,798

Taxes payable includes Value Added Tax, sales tax, property tax, and income tax payables.

Accrued purchases reflects liabilities related to the construction of the Gigafactory along with engineering design and testing accruals. As these services are invoiced, this balance will reduce and accounts payable will increase.

Note 7 - Customer Deposits

Customer deposits include cash payments from customers at the time they place an order for a vehicle and additional payments up to the point of delivery including the fair value of customer trade-in vehicles that are applicable toward a new vehicle purchase. Customer deposit amounts and timing vary depending on the vehicle model and country of delivery. Customer deposits are fully refundable up to the point the vehicle is placed into the production cycle. Customer deposits are included in current liabilities until refunded or until they are applied to a customer’s purchase balance at time of delivery.

As of June 30, 2016 and December 31, 2015, we held customer deposits of \$679.8 million and \$283.4 million. The increase is primarily due to Model 3 deposits.

Note 8 - Convertible and Long-term Debt Obligations

0.25% and 1.25% Convertible Senior Notes and Bond Hedge and Warrant Transactions

In March 2014, we issued \$800.0 million principal amount of 0.25% convertible senior notes due 2019 (2019 Notes) and \$1.20 billion principal amount of 1.25% convertible senior notes due 2021 (2021 Notes) in a public offering. In April 2014, we issued an additional \$120.0 million aggregate principal amount of 2019 Notes and \$180.0 million aggregate principal amount of 2021 Notes, pursuant to the exercise in full of the overallotment options of the underwriters of our March 2014 public offering. The total net proceeds from these offerings, after deducting transaction costs, were approximately \$905.8 million from 2019 Notes and \$1.36 billion from 2021 Notes. We incurred \$14.2 million and \$21.4 million of debt issuance costs in connection with the 2019 Notes and the 2021 Notes and are amortizing to interest expense using the effective interest method over the contractual terms of these notes. In April 2015, the FASB issued new authoritative accounting guidance on simplifying the presentation of debt issuance costs, which we retrospectively adopted as of March 31, 2016 and reclassified debt issuance costs in connection with the notes to related debt liability. The interest rates are fixed at 0.25% and 1.25% per annum and are payable semi-annually in arrears on March 1 and September 1 of each year, commencing on September 1, 2014.

Each \$1,000 of principal of these notes is initially convertible into 2.7788 shares of our common stock, which is equivalent to an initial conversion price of approximately \$359.87 per share, subject to adjustment upon the occurrence of specified events. Holders of these notes may convert their notes at their option on or after December 1, 2018 for the 2019 Notes and on or after December 1, 2020 for the 2021 Notes. Further, holders of these notes may convert their notes at their option prior to the respective dates above, only under the following circumstances: (1) during any fiscal quarter beginning after the fiscal quarter ending June 30, 2014, if the last reported sale price of our common stock for at least 20 trading days (whether or not consecutive) during the last 30 consecutive trading days of immediately preceding fiscal quarter is greater than or equal to 130% of the conversion price of the applicable notes on each applicable trading day; (2) during the five business day period following any five consecutive trading day period in which the trading price for the applicable notes is less than 98% of the average of the closing sale price of our common stock for each day during such five trading day period; or (3) if we make specified distributions to holders of our common stock or if specified corporate transactions occur. Upon conversion of the 2019 Notes, we would pay or deliver as applicable, cash, shares of our common stock or a combination of cash and shares of our common stock, at our election. Upon conversion of the 2021 Notes, we would pay the holders in cash for the principal amount and, if applicable, shares of our common stock (subject to our right to deliver cash in lieu of all or a portion of such shares of our common stock) based on a daily conversion value. If a fundamental change occurs prior to the maturity date, holders of these notes may require us to repurchase all or a portion of their notes for cash at a repurchase price equal to 100% of the principal amount of the notes, plus any accrued and unpaid interest. In addition, if specific corporate events occur prior to the applicable maturity date, we will increase the conversion rate for a holder who elects to convert their notes in connection with such a corporate event in certain circumstances. During the second quarter of 2016, the closing price of our common stock did not meet or exceed 130% of the applicable conversion price of our 2019 Notes and 2021 Notes on at least 20 of the last 30 consecutive trading days of the quarter; furthermore, no other conditions allowing holders of these notes to convert have been met as of June 30, 2016. Therefore, the 2019 Notes and 2021 Notes are not convertible during the third quarter of 2016 and are classified as long-term debt. Should the closing price conditions be met in the third quarter of 2016 or a future quarter, the 2019 and/or the 2021 Notes will be convertible at their holders' option during the immediately following quarter. As of June 30, 2016, the if-converted value of the 2019 Notes and 2021 Notes did not exceed the principal value of those notes.

In accordance with accounting guidance on embedded conversion features, we valued and bifurcated the conversion option associated with the notes from the respective host debt instrument and initially recorded the conversion option of \$188.1 million for the 2019 Notes and \$369.4 million for the 2021 Notes in stockholders' equity. The resulting debt discounts on the 2019 Notes and 2021 Notes are being amortized to interest expense at an effective interest rate of 4.89% and 5.96%, respectively, over the contractual terms of the notes.

In connection with the offering of these notes in March 2014, we entered into convertible note hedge transactions whereby we have the option to purchase initially (subject to adjustment for certain specified events) a total of approximately 5.6 million shares of our common stock at a price of approximately \$359.87 per share. The total cost of the convertible note hedge transactions was \$524.7 million. In addition, we sold warrants whereby the holders of the warrants have the option to purchase initially (subject to adjustment for certain specified events) a total of approximately 2.2 million shares of our common stock at a price of \$512.66 for the 2019 Notes and a total of approximately 3.3 million shares of our common stock at a price of \$560.64 per share for 2021 Notes. We received \$338.4 million in cash proceeds from the sale of these warrants. Similarly, in connection with the issuance of additional notes in April 2014, we entered into convertible note hedge transactions and paid an aggregate \$78.7 million. In addition, we sold warrants to purchase (subject to adjustment for certain specified events) a total of approximately 0.3 million shares of our common stock at a price of \$512.66 per share for the warrants relating to 2019 Notes, and a total of approximately 0.5 million shares of our common stock at a price of \$560.64 per share for the warrants relating to 2021 Notes. We received aggregate proceeds of approximately \$50.8 million from the sale of the warrants. Taken together, the purchase of the convertible note hedges and the sale of warrants are intended to reduce potential dilution and/or offset potential cash payments upon the conversion of these notes and to effectively increase the overall conversion price from \$359.87 to \$512.66 per share in the case of warrants relating to 2019 Notes and from \$359.87 to \$560.64 in the case of warrants relating to 2021 Notes. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity and are not accounted for as derivatives. The net cost incurred in connection with the convertible note hedge and warrant transactions was recorded as a reduction to additional paid-in capital on the consolidated balance sheet.

1.50% Convertible Senior Notes and Bond Hedge and Warrant Transactions

In May 2013, we issued \$660.0 million aggregate principal amount of 2018 Notes in a public offering. The net proceeds from the offering, after deducting transaction costs, were approximately \$648.0 million. We incurred \$12.0 million of debt issuance costs in connection with the issuance of the 2018 Notes and are amortizing to interest expense using the effective interest method over the contractual term of the 2018 Notes. The interest under the 2018 Notes is fixed at 1.50% per annum and is payable semi-annually in arrears on June 1 and December 1 of each year, commencing on December 1, 2013.

Each \$1,000 of principal of the 2018 Notes is initially convertible into 8.0306 shares of our common stock, which is equivalent to an initial conversion price of approximately \$124.52 per share, subject to adjustment upon the occurrence of specified events. Holders of the 2018 Notes may convert their 2018 Notes at their option on or after March 1, 2018. Further, holders of the 2018 Notes may convert their 2018 Notes at their option prior to March 1, 2018, only under the following circumstances: (1) during any fiscal quarter beginning after the fiscal quarter ending September 30, 2013, if the last reported sale price of our common stock for at least 20 trading days (whether or not consecutive) during the last 30 consecutive trading days of the immediately preceding fiscal quarter is greater than or equal to 130% of the conversion price on each applicable trading day; (2) during the five business day period following any five consecutive trading day period in which the trading price for the 2018 Notes is less than 98% of the average of the closing sale price of our common stock for each day during such five trading day period; or (3) if we make specified distributions to holders of our common stock or if specified corporate transactions occur. Upon conversion, we would pay the holders in cash for the principal amount of the 2018 Notes and, if applicable, shares of our common stock (subject to our right to deliver cash in lieu of all or a portion of such shares of our common stock) based on a calculated daily conversion value. If a fundamental change occurs prior to the maturity date, holders of the 2018 Notes may require us to repurchase all or a portion of their 2018 Notes for cash at a repurchase price equal to 100% of the principal amount of the 2018 Notes, plus any accrued and unpaid interest. In addition, if specific corporate events occur prior to the maturity date, we will increase the conversion rate for a holder who elects to convert its 2018 Notes in connection with such a corporate event in certain circumstances.

In accordance with accounting guidance on embedded conversion features, we valued and bifurcated the conversion option associated with the 2018 Notes from the host debt instrument and recorded the conversion option of \$82.8 million in stockholders' equity. The resulting debt discount on the 2018 Notes is being amortized to interest expense at an effective interest rate of 4.29% over the contractual term of the 2018 Notes.

In connection with the offering of the 2018 Notes, we entered into convertible note hedge transactions whereby we have the option to purchase initially (subject to certain specified events) a total of approximately 5.3 million shares of our common stock at a price of approximately \$124.52 per share. The cost of the convertible note hedge transactions was \$177.5 million. In addition, we sold warrants whereby the holders of the warrants have the option to purchase initially (subject to certain specified events) a total of approximately 5.3 million shares of our common stock at a price of \$184.48 per share. We received \$120.3 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and the sale of warrants are intended to offset any actual dilution from the conversion of the 2018 Notes and to effectively increase the overall conversion price from \$124.52 to \$184.48 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity and are not accounted for as derivatives. The net cost incurred in connection with the convertible note hedge and warrant transactions was recorded as a reduction to additional paid-in capital on the consolidated balance sheet as of December 31, 2015.

During the first and second quarter of 2016, the closing price of our common stock exceeded 130% of the applicable conversion price of our 2018 Notes on at least 20 of the last 30 consecutive trading days of the quarter; therefore, holders of 2018 Notes may convert their notes during the second and third quarter of 2016. As such, we classified the \$608.9 million carrying value of our 2018 Notes as current liabilities and classified \$37.1 million, representing the difference between the aggregate principal of our 2018 Notes of \$646.1 million and the carrying value of 2018 Notes, as mezzanine equity on our consolidated balance sheet as of June 30, 2016. Should the closing price conditions be met in the third quarter of 2016 or a future quarter, 2018 Notes will be convertible at their holders' option during the immediately following quarter.

Convertible Senior Notes Carrying Value and Interest Expense

In accordance with accounting guidance on embedded conversion features, we valued and bifurcated the conversion option associated with the Notes from the respective host debt instrument and initially recorded the conversion option for the 2018, 2019, and 2021 Notes in stockholders' equity. The resulting debt discounts on the 2018 Notes, 2019 Notes, and 2021 Notes are being amortized to interest expense at the effective interest rate over the contractual terms of the Notes.

	June 30, 2016			December 31, 2015		
	2018 Notes	2019 Notes	2021 Notes	2018 Notes	2019 Notes	2021 Notes
	(in thousands, except years and percentages)					
Carrying value	\$ 608,931	\$ 807,464	\$ 1,105,934	\$ 612,476	\$ 788,004	\$ 1,080,867
Unamortized discount and issuance costs	37,146	112,536	274,066	47,285	131,996	299,133
Principal amount	<u>\$ 646,077</u>	<u>\$ 920,000</u>	<u>\$ 1,380,000</u>	<u>\$ 659,761</u>	<u>\$ 920,000</u>	<u>\$ 1,380,000</u>
Remaining amortization period (years)	1.9	2.7	4.7			
Effective interest rate on liability component	4.29%	4.89%	5.96%			
Initial equity component	\$ 82,800	\$ 188,100	\$ 369,400			
If converted, value in excess of par value	\$ 455,333					

Asset-Based Credit Agreement

In June 2015, we entered into a senior secured asset-based revolving credit agreement (the "Credit Agreement") with a syndicate of banks. The Credit Agreement provides for a senior secured asset-based revolving credit facility (the "Credit Facility"), which we may draw upon as needed. In October 2015, lenders increased their total funding commitments to us under the Credit Facility by up to an additional \$250.0 million, subject to certain conditions, for total commitments up to \$750 million. In addition, the Credit Agreement provides for a \$200.0 million letter of credit sub-facility and a \$40.0 million swing-line loan sub-facility. The Credit Agreement is collateralized by a pledge of certain of our accounts receivable, inventory, and equipment, and availability under the Credit Agreement is based on the value of such assets, as reduced by certain reserves. In February 2016, we amended the Credit Agreement and increased the availability and the commitments under the Credit Agreement from \$750.0 million to \$1.0 billion.

Borrowed funds bear interest, at our option, at an annual rate of (a) 1% plus LIBOR or (b) the highest of (i) the federal funds rate plus 0.50%, (ii) the lenders "prime rate" or (iii) 1% plus LIBOR. The fee for undrawn amounts is 0.25% per annum. Interest is payable quarterly. The Credit Agreement terminates, and all outstanding loans become due and payable, in June 2020. As of June 30, 2016, we had \$678.0 million in borrowings under the Credit Facility and zero borrowings under the swing-line loan sub-facility. In July 2016, we repaid \$678.0 million of the outstanding balance.

We are required to meet various covenants, including meeting certain reporting requirements, such as the completion and presentation of audited consolidated financial statements for our borrowings. As of June 30, 2016 we were in compliance with all covenants contained in the Credit Agreement.

Pledged Assets

As of June 30, 2016 and December 31, 2015, we have pledged or restricted \$1.82 billion and \$1.43 billion principally from finished goods and raw materials inventory, as well as certain property and equipment, direct lease vehicles, receivables and cash as collateral for letters of credit including our Credit Agreement, real estate leases, and insurance policies.

Interest Expense

The following table presents the aggregate amount of interest expense recognized on the Warehouse Facility (terminated December 2015), Credit Agreement, 2018 Notes, 2019 Notes, and 2021 Notes relating to the contractual interest coupon and amortization of the debt issuance costs and debt discount, in thousands:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Contractual interest coupon	\$ 8,324	\$ 7,741	\$ 16,715	\$ 15,048
Amortization of debt issuance costs	1,985	1,727	3,883	3,257
Amortization of debt discount	25,642	24,213	50,833	47,851
Total	<u>\$ 35,951</u>	<u>\$ 33,681</u>	<u>\$ 71,431</u>	<u>\$ 66,156</u>

Note 9 - Equity Incentive Plans

In July 2003, we adopted the 2003 Equity Incentive Plan. Concurrent with the effectiveness of our registration statement on Form S-1 on June 28, 2010, we adopted the 2010 Equity Incentive Plan (the Plan) and all remaining common shares reserved for future grant or issuance under the 2003 Equity Incentive Plan were added to the 2010 Equity Incentive Plan. The Plan provides for the granting of stock options, RSUs and stock purchase rights to our employees, directors and consultants. Options granted under the Plan may be either incentive options or nonqualified stock options. Incentive stock options may be granted only to our employees including officers and directors. Nonqualified stock options and stock purchase rights may be granted to our employees and consultants. Generally, our stock options and RSUs vest over four years and are exercisable over a period not to exceed the contractual term of ten years from the date the stock options are granted. Continued vesting typically terminates when the employment or consulting relationship ends. As of June 30, 2016, 15,069,690 shares of common stock were reserved for issuance under the Plan. As of June 30, 2016 and December 31, 2015, 1,677,778 and 2,816,785 shares were available for grant relating to stock options and RSUs.

Performance-based Stock Option Grant

In 2014, to create incentives for continued long term success beyond the Model S program and to closely align executive pay with our stockholders' interests in the achievement of significant milestones by our Company, the Compensation Committee of our Board of Directors granted stock options to certain employees to purchase an aggregate 1,073,000 shares of our common stock. Each such grant consists of four vesting tranches with a vesting schedule based entirely on the attainment of future performance milestones, assuming continued employment and service to us through each vesting date.

- 1/4th of the shares subject to the options are scheduled to vest upon completion of the first Model X Production Vehicle;
- 1/4th of the shares subject to the options are scheduled to vest upon achieving aggregate vehicle production of 100,000 vehicles in a trailing 12-month period;
- 1/4th of the shares subject to the options are scheduled to vest upon completion of the first Model 3 Production Vehicle; and
- 1/4th of the shares subject to the options are scheduled to vest upon achievement of annualized gross margin of greater than 30.0% in any three years.

As of June 30, 2016, the following performance milestone was achieved and approved by our Board of Directors.

- Completion of the first Model X Production Vehicle

As of June 30, 2016, the following performance milestone was considered probable of achievement:

- Completion of the first Model 3 Production Vehicle

We begin recording stock-based compensation expense as each milestone becomes probable. For the three and six months ended June 30, 2016, we recorded stock-based compensation expense of \$2.1 million and \$11.1 million related to this grant. For the three and six months ended June 30, 2015, we recorded stock-based compensation expense of \$4.0 million and \$7.7 million related to this grant.

2012 CEO Grant

In August 2012, our Board of Directors granted 5,274,901 stock options to our CEO (2012 CEO Grant). The 2012 CEO Grant consists of ten vesting tranches with a vesting schedule based entirely on the attainment of both performance conditions and market conditions, assuming continued employment and service to us through each vesting date.

Each of the ten vesting tranches requires a combination of one of the ten pre-determined performance milestones and an incremental increase in our market capitalization of \$4.0 billion, as compared to the initial market capitalization of \$3.2 billion measured at the time of the 2012 CEO Grant.

As of June 30, 2016, the market conditions for seven vesting tranches and the following five performance milestones were achieved and approved by our Board of Directors:

- Successful completion of the Model X Alpha Prototype;
- Successful completion of the Model X Beta Prototype;
- Completion of the first Model X Production Vehicle;
- Aggregate vehicle production of 100,000 vehicles; and
- Successful completion of the Model 3 Alpha Prototype.

As of June 30, 2016, the following performance milestones were considered probable of achievement:

- Successful completion of the Model 3 Beta Prototype;
- Completion of the first Model 3 Production Vehicle; and
- Aggregate vehicle production of 200,000 vehicles.

We begin recording stock-based compensation expense as each milestone becomes probable. We recorded an immaterial amount of stock-based compensation expense for the three months period ended June 30, 2016 and \$10.3 million for the six months period ended June 30, 2016 related to this grant. For the three and six months ended June 30, 2015, we recorded stock-based compensation expense of \$1.3 million and \$2.7 million related to this grant.

Our CEO earns a base salary that reflects the currently applicable minimum wage requirements under California law, and he is subject to income taxes based on such base salary. However, he has never accepted and currently does not accept his salary.

Summary Stock-Based Compensation Information

The following table summarizes our stock-based compensation expense by line item in the consolidated statements of operations (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2016	2015	2016	2015
Cost of revenues	\$ 6,495	\$ 4,820	\$ 12,898	\$ 9,421
Research and development	33,506	19,912	73,108	39,704
Selling, general and administrative	27,311	18,603	70,963	37,236
Total	<u>\$ 67,312</u>	<u>\$ 43,335</u>	<u>\$ 156,969</u>	<u>\$ 86,361</u>

Note 10 - Commitments and Contingencies

Legal Proceedings

From time to time, we are subject to various legal proceedings that arise from the normal course of business activities. In addition, from time to time, third parties may assert intellectual property infringement claims against us in the form of letters and other forms of communication. If an unfavorable ruling were to occur, there exists the possibility of a material adverse impact on our results of operations, prospects, cash flows, financial position and brand.

In November 2013, a putative securities class action lawsuit was filed against Tesla in U.S. District Court, Northern District of California, alleging violations of, and seeking remedies pursuant to, Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5. The complaint made claims against Tesla and our CEO, Elon Musk, sought damages and attorney's fees on the basis of allegations that, among other things, Tesla and Mr. Musk made false and/or misleading representations and omissions, including with respect to the safety of Model S. This case was brought on behalf of a putative class consisting of certain persons who purchased Tesla's securities between August 19, 2013 and November 17, 2013. On September 26, 2014, the trial court, upon the motion of Tesla and Mr. Musk, dismissed the complaint with prejudice, and thereafter issued a formal written order to that effect. The plaintiffs have appealed from the trial court's order, and that appeal is pending.

From time to time, we have received requests for information from regulators and governmental authorities, such as the National Highway Traffic Safety Administration, the National Transportation Safety Board and the Securities and Exchange Commission. We are also subject to various other legal proceedings that arise from the normal course of business activities. In addition, from time to time, third parties may assert intellectual property infringement claims against us in the form of letters and other forms of communication. If an unfavorable ruling were to occur, there exists the possibility of a material adverse impact on our results of operations, prospects, cash flows, financial position and brand.

Note 11 – Subsequent events

2018 Notes Conversion

Subsequent to June 30, 2016, we have received additional conversion notices from certain holders of our 2018 Notes which require cash outlays to repay the principal portion of our 2018 Notes. The total amount of notices received to date is for principal value of approximately \$411 million, which we expect to pay during the third quarter of 2016.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis should be read in conjunction with our consolidated financial statements and the related notes that appear elsewhere in this Quarterly Report on Form 10-Q.

Overview

We design, develop, manufacture, and sell high-performance fully electric vehicles, and energy products. We are currently producing and selling our Model S sedan and our Model X sport utility vehicle. We continue to enhance our vehicle offerings with all-wheel drive capability, autopilot options, and free over-the-air software updates. We commenced customer deliveries of Model X in September 2015 and continue to ramp production. We unveiled Model 3, a lower priced sedan designed for the mass market, in the first quarter of 2016 which received significant interest.

In addition to our automotive products, we continue to sell our energy products, the 7 kWh Powerwall for residential applications and the 100 kWh Powerpack for commercial and industrial applications. We began production and deliveries of these products in the third quarter of 2015. We transitioned the production of these products from the Tesla Factory to the Gigafactory during the fourth quarter of 2015.

Our primary source of revenue is from the sale of our vehicles. During the quarter ended June 30, 2016, we recognized total revenues of \$1.27 billion, an increase of \$315.0 million over total revenues of \$955.0 million for the quarter ended June 30, 2015, primarily driven by growth of vehicle deliveries worldwide, including introduction of Model X during the third quarter of fiscal 2015. Gross margin for the quarter ended June 30, 2016 was 21.6%, a decrease from 22.3% for the quarter ended June 30, 2015.

We continue to increase our sales and service footprint worldwide and expand our Supercharging and destination charging networks. With the continued global expansion of our customer support infrastructure, selling, general and administrative expenses were \$321.2 million for the quarter ended June 30, 2016, compared to \$201.8 million for the quarter ended June 30, 2015.

Management Opportunities, Challenges and Risks

Demand, Production and Deliveries

We are currently producing and selling both the Model S sedan and the Model X sport utility vehicle. We have broadened the appeal of these vehicles by introducing new variants that improve range, performance, and value, and we expect to introduce further new versions and functionality over time. Overall, we expect that demand for our vehicles will continue to increase worldwide as more people drive and become aware of our vehicles, as we grow our customer sales, service and charging infrastructure, as we continue to offer less expensive vehicles such as Model 3, and as we continue to develop our vehicles.

We continue to make progress in increasing vehicle production and plan to continue increasing total vehicle production to support approximately 50,000 deliveries in the second half of this year. In the second quarter of 2016, we produced 18,345 vehicles, including about 6,200 Model X vehicles. Total second quarter production increased 18% from the first quarter. We exited the quarter consistently producing nearly 2,000 vehicles per week. Our Model X production ramp has faced challenges, including supplier part shortages, yet we continue to make steady progress. With continued productivity improvements, and barring any further supply constraints, we plan to exit the third quarter with a steady production rate of 2,200 vehicles per week, and plan to increase production to 2,400 vehicles per week in the fourth quarter of this year.

In addition, we are on track to achieve volume production and deliveries of Model 3 in late 2017. In order to meet that timeframe, we are holding both ourselves and our suppliers accountable to be ready for volume production in advance of that timing. We expect our production will increase considerably each year for the next several years, and are targeting an overall vehicle production level of 500,000 vehicles, including Model S, Model X and Model 3, in 2018. Increasing production five fold over the next two years will be challenging and will likely require additional capital, but this is our goal and we are working hard to achieve it.

In addition to expanding our vehicle production and deliveries, we expect to continue to lower the cost of manufacturing our vehicles over the next several quarters due to economies of scale, material cost reductions and more efficient manufacturing. We expect that this trend will contribute to improve automotive gross margin over time, excluding the impact of foreign currency movements. Significant cost improvements for Model S were achieved in 2014 and 2015 relating to material cost reductions from both engineering and commercial actions, and manufacturing efficiencies, excluding the impact of newly introduced Model S variants and Model X. However, during our product introductions over the last few years, we encountered manufacturing inefficiencies and supplier constraints which negatively impacted our gross margin. If we are not able to achieve the planned cost reductions from our

various cost savings and process improvement initiatives or ramp Model X efficiently, our ability to reach our gross margin goals would be negatively affected.

We are expanding our sales, service and charging infrastructure worldwide to accommodate a much larger fleet of vehicles and provide timely customer services in areas with a high concentration of Tesla customers. In particular, we are on plan to open more than 60 additional retail and service locations in 2016, to bring our total to nearly 280 locations worldwide. Because we sell our vehicles in many countries throughout North America, Europe and Asia, and our retail and service expansion will primarily occur in geographic areas in which we already have a presence, we expect our long-term sales outside of North America will be over half of our worldwide automotive revenue. As compared to markets in the United States, we have relatively limited experience in international markets, and thus we may face difficulties meeting our future international expansion plans with respect to timing and expected sales. If we experience unexpected difficulties or delays in finding or opening desirable locations for stores and service centers, we may not be able to meet our delivery plans and sales goals.

Trends in Cash Flow, Capital Expenditures and Operating Expenses

We have advanced our 500,000 total unit build plan by two years to 2018. Given this plan, we expect to invest approximately \$2.25 billion in capital expenditure for the full year of 2016. Our capital expenditure needs include expenditures for the tooling, production equipment and construction of the Model 3 production lines, equipment to support cell production at the Gigafactory, as well as new retail locations service centers and Supercharger locations.

While we are also currently in the process of evaluating our operating expenditures given our revised vehicle build plan, we currently expect operating expenses to grow by approximately 30% in 2016 as compared to 2015, excluding any potential impact from the future SolarCity acquisition. This increase is driven by engineering, design, and testing expenses related to Model 3 supplier contracts and higher sales and service costs associated with expanding our geographic presence. We expect selling, general and administrative expenses to decline over time as a percentage of revenue as we focus on increasing operational efficiency while continuing to expand our customer and corporate infrastructure. Over time, we also expect total operating expenses to decrease as a percentage of revenue.

As of June 30, 2016 and December 31, 2015, the net book value of our Supercharger network was \$180.0 million and \$166.6 million, and as of June 30, 2016 our Supercharger network included 661 locations globally. We plan to continue investing in our Supercharger network for the foreseeable future, including in North America, Europe and Asia, and expect such spending to continue to be a minimal portion of total capital spending during 2016. During 2016, we expect that this investment will grow our Supercharger network over 40%. We allocate Supercharger related expenses to cost of automotive revenues and selling, general, and administrative expenses. These costs were immaterial for all periods presented.

Customer Financing Options

We offer loans and leases in North America, Europe and Asia primarily through various financial institutions. We offer a resale value guarantee in connection with certain loans offered by financial institutions and as of June 30, 2016 had approximately 22,480 vehicles under this program. We recently discontinued the resale value guarantee in North America, but continue to offer it in selected European and Asian markets. Resale value guarantees available for exercise within the next 12 months total \$227.8 million in value and relate to 4,969 vehicles.

Vehicle deliveries with the resale value guarantee do not impact our near-term cash flows and liquidity, since we receive the full amount of cash for the vehicle sales price at delivery. However, this program requires the deferral of revenues and costs into future periods as they are considered leases for accounting purposes.

While we do not assume any credit risk related to the customer, if a customer exercises the option to return the vehicle to us, we are exposed to liquidity risk that the resale value of vehicles under these programs may be lower than our guarantee, or the volume of vehicles returned to us may be higher than our estimates, or we may be unable to resell the used cars in a timely manner, all of which could adversely impact our cash flows. Alternatively, in cases where customers retain their vehicles past the expiration of the guarantee period, the remaining deferred revenues and costs will be recognized at no gross profit.

Based on current market demand for our cars, we estimate the resale prices for our vehicles will continue to be above our resale value guarantee amounts. Should market values of our vehicles or customer demand decrease, these estimates may be impacted materially.

We currently offer leases in the U.S. directly from our captive financing entity, as well as through a leasing partner. Leasing through Tesla Finance is now available in 39 states and the District of Columbia. We also offer financing arrangements through

entities in Canada, Germany and the U.K. As of June 30, 2016, we have active leases for approximately 6,180 vehicles through our captive financing entities and approximately 11,280 vehicles through our leasing partner. Leasing through both our captive financing entities and our leasing partner exposes us to residual value risk and will adversely impact our near-term operating results by requiring the deferral of revenues and costs into future periods under lease accounting. In addition, for leases offered directly from our captive financing entities (but not for those offered through our bank partner), we only receive a limited portion of cash for the vehicle price at delivery and will assume customer credit risk. We plan to continue expanding our financing offerings, including our lease financing options and the financial sources to support them, to support the overall financing needs of our customers. To the extent that we are unable to arrange such options for our customers on terms that are attractive, our sales, financial results and cash flow could be negatively impacted.

The Gigafactory

We are developing the Gigafactory as a facility where we work together with our suppliers to integrate production of battery material, cells, modules and battery packs in one location. We broke ground on the Gigafactory in June 2014 and began assembling our energy products in the first portion of the facility in the fourth quarter of 2015. We currently expect to produce cells at the Gigafactory beginning in the fourth quarter of 2016 for use initially in our energy products and later for our vehicles. Our revised vehicle build plan also includes an adjustment of our cell production plans at the Gigafactory.

We continue to invest in construction of the building and utilities at the Gigafactory and in production equipment for battery, module and pack production. We are responsible for the overall management of the Gigafactory and will engage with partners who have significant experience in battery cell and material production. Panasonic has agreed to partner with us on the Gigafactory with investments in production equipment that it will use to manufacture and supply us with battery cells. Under our arrangement with Panasonic, we plan to purchase the full output from their production equipment located at the Gigafactory at negotiated prices. As these terms convey a right to use the production related assets as defined within ASC 840 – *Leases*, we will consider these leased assets beginning with the start of cell production in 2016. This will result in us recording the value of such assets within property, plant, and equipment in our consolidated balance sheet with a corresponding liability recorded to financing obligations.

Given the size and complexity of this undertaking, the cost of building and operating the Gigafactory could exceed our current expectations and the Gigafactory may take longer to bring online than we anticipate.

Critical Accounting Policies and Estimates

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States. The preparation of these consolidated financial statements requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues, costs and expenses and related disclosures. We base our estimates on historical experience, as appropriate, and on various other assumptions that we believe to be reasonable under the circumstances. Changes in the accounting estimates are reasonably likely to occur from period to period. Accordingly, actual results could differ significantly from the estimates made by our management. We evaluate our estimates and assumptions on an ongoing basis. To the extent that there are material differences between these estimates and actual results, our future financial statement presentation, financial condition, results of operations and cash flows will be affected.

For a description of our critical accounting policies and estimates, please refer to the “Critical Accounting Policies and Estimates” section of our Management’s Discussion and Analysis of Financial Condition and Results of Operations contained in our Annual Report on Form 10-K for the year ended December 31, 2015, as filed with the Securities and Exchange Commission (SEC). In addition, please refer to Note 2, “Summary of Significant Accounting Policies,” to our Consolidated Financial Statements included under Part I, Item 1 of this Quarterly Report on Form 10-Q which also includes discussion of Recent Accounting Pronouncements that may impact us.

Results of Operations

Revenues

Automotive revenue includes revenues related to deliveries of new Model S and Model X vehicles, including internet connectivity, Supercharger access, and specified software updates for cars equipped with Autopilot hardware, as well as sales of regulatory credits to other automotive manufacturers, amortization of revenue for cars sold with resale value guarantees, and Model S and Model X leasing revenue.

Services and other revenue consists of sales of electric vehicle powertrain components and systems to other manufacturers, maintenance and development services, energy products, and pre-owned vehicles.

Automotive revenue during the three and six months ended June 30, 2016 were \$1.18 billion and \$2.21 billion, an increase from \$878.1 million and \$1.77 billion during the three and six months ended June 30, 2015. The increase was primarily driven by an increase in vehicle deliveries as well as an increase in the active population of cars subject to lease accounting. For the three and six months ended June 30, 2016, automotive revenue includes \$151.6 million and \$275.8 million from the accretion of the deferred revenues from our resale value guarantee and other similar programs, as well as Model S and Model X leasing, an increase from \$69.5 million and \$123.2 million during the three and six months ended June 30, 2015.

Service and other revenue during the three and six months ended June 30, 2016 were \$88.2 million and \$209.1 million, an increase from \$76.9 million and \$123.4 million during the three and six months ended June 30, 2015, related primarily to increases in pre-owned vehicle sales, energy product sales, and maintenance service revenue.

Cost of Revenues and Gross Profit

Cost of revenues includes direct parts, material and labor costs, manufacturing overhead, including amortized tooling costs, royalty fees, shipping and logistic costs, vehicle connectivity costs, allocations of electricity and infrastructure costs related to our Supercharger network, and reserves for estimated warranty expenses. Cost of revenues also includes adjustments to warranty expense and charges to write down the carrying value of our inventory when it exceeds its estimated net realizable value and to provide for obsolete and on-hand inventory in excess of forecasted demand.

Cost of automotive revenues during the three and six months ended June 30, 2016, were \$909.3 million and \$1.69 billion, an increase from \$666.4 million and \$1.30 billion for the three and six months ended June 30, 2015. The increase in cost of automotive revenues was driven primarily by Model X deliveries, which commenced in the third quarter of 2015. In the three and six months ended June 30, 2016, we recognized \$76.7 million and \$138.9 million in cost of automotive revenues related to cars accounted for as operating leases. In the three and six months ended June 30, 2015, we recognized \$36.0 million and \$67.4 million in cost of automotive revenues related to cars accounted for as operating leases.

Cost of services and other revenue during the three and six months ended June 30, 2016 were \$86.0 million and \$201.2 million, an increase from \$75.2 million and \$123.3 million for the three and six months ended June 30, 2015. The increase in cost of services and other revenues was driven primarily by greater pre-owned vehicle sales, energy product sales, and maintenance services sales.

Gross profit for the three and six months ended June 30, 2016 was \$274.8 million and \$527.2 million, an increase from \$213.4 million and \$473.4 million during the three and six months ended June 30, 2015. Gross margin for the three and six months ended June 30, 2016 was 21.6% and 21.8%, a decrease of 0.7% and 3.2% from the three and six months ended June 30, 2015. The lower gross margin was primarily due to product mix shift, as a greater percentage of sales were derived from Model X. This margin decrease was also offset by an increasing amount of revenues from vehicles accounted for as leases including direct lease vehicles and those under our resale value guarantee programs which have a significantly higher gross margin and from material cost savings. Services and other gross margin improved year over year, primarily driven by a mix shift away from lower margin powertrain sales to Daimler.

Research and Development Expenses

Research and development (R&D) expenses consist primarily of personnel costs for our teams in engineering and research, supply chain, quality, manufacturing engineering and manufacturing test organizations, prototyping expense, contract and professional services and amortized equipment expense.

R&D expenses for the three months ended June 30, 2016 were \$191.7 million, an increase from \$181.7 million for the three months ended June 30, 2015. The increase in R&D expenses consisted primarily of a \$13.6 million increase in stock-based compensation expense related to increased headcount and number of awards granted, a \$9.0 million increase in employee and labor related expenses, partially offset by a \$8.4 million decrease in outside services, a \$6.4 million decrease in expensed materials related to our Model X development.

R&D expenses for the six months ended June 30, 2016 were \$374.1 million, an increase from \$348.9 million for the six months ended June 30, 2015. The increase in R&D expenses consisted primarily of a \$33.4 million increase in stock-based compensation expense related to increased headcount and number of awards granted, a \$28.9 million increase in employee and labor related expenses, partially offset by a \$29.2 million decrease in expensed materials related to our Model X development, a \$7.1 million reduction in facility and other cost efficiencies, and a \$6.5 million decrease in outside services.

Selling, General and Administrative

Selling, general and administrative (SG&A) expenses consist primarily of personnel and facilities costs related to our Tesla stores, marketing, sales, executive, finance, human resources, information technology and legal organizations, as well as litigation settlements and fees for professional and contract services.

SG&A expenses for the three months ended June 30, 2016 were \$321.2 million, an increase from \$201.8 million for the three months ended June 30, 2015. SG&A expenses increased primarily from higher headcount and costs, including stock based compensation, to support an expanded retail, service and Supercharger footprint as well as the general growth of the business. The increase in our SG&A expenses consisted primarily of a \$86.2 million increase in employee and labor related expenses due to higher headcount, a \$24.4 million increase in office, information technology and facilities-related costs to support the growth of our business as well as sales and marketing activities to handle our expanding market presence, and a \$8.7 million increase in stock-based compensation expense related to increased headcount.

SG&A expenses for the six months ended June 30, 2016 were \$639.4 million, an increase from \$397.2 million for the six months ended June 30, 2015. The increase in our SG&A expenses consisted primarily of a \$142.4 million increase in employee and labor related expenses due to higher sales and marketing headcount to support growing sales activities worldwide and higher general and administrative headcount to support the expansion of the business, a \$66.4 million increase in office, information technology and facilities-related costs to support sales and marketing activities and the growth of our business, and a \$33.7 million increase in stock-based compensation related to increased headcount,

Interest Expense

Interest expense for the three and six months ended June 30, 2016 was \$46.4 million and \$87.0 million, as compared to \$24.4 million and \$50.9 million during the three and six months ended June 30, 2015. The increase as compared to the same period in the prior year was due to an increase in interest expense on vehicles sales that we account for as collateralized borrowing, as well as increased interest expense on build-to-suite leases, and on higher balances of outstanding debt.

Other Income (Expense), Net

Other income (expense), net, consists primarily of foreign exchange gains and losses related to our foreign currency-denominated assets and liabilities. We expect our foreign exchange gains and losses will vary depending upon movements in the underlying exchange rates.

Other income (expense) was (\$7.4) million and \$1.8 million in the three and six months ended June 30, 2016, as compared to \$13.2 million and (\$9.1) million during the same period in 2015. Fluctuations in other income (expense) are primarily the result of gains (losses) from foreign currency exchange of (\$7.2) million and \$0.8 million in the three and six months ended June 30, 2016, and \$12.8 million and (\$8.8) million during the same period in 2015.

Provision for Income Taxes

Our provision for income taxes for the three and six months ended June 30, 2016, was \$3.6 million and \$7.5 million, compared to \$3.2 million and \$6.2 million during the three and six months ended June 30, 2015. The increases in the provision for income taxes were due primarily to an increase in taxable income in our international jurisdictions.

Liquidity and Capital Resources

As of June 30, 2016, we had \$3.25 billion in principal sources of liquidity available from our cash and cash equivalents, which included \$2.76 billion of money market funds. This balance reflects cash proceeds of \$1.7 billion from the public offering completed in May 2016 of 7,915,004 shares of common stock, net of underwriting discounts and offering costs. In addition, this balance also reflects \$678.0 million drawn under our asset based line of credit, which was repaid in full as of July 2016. Amounts held in foreign currencies had a U.S. dollar equivalent of \$449.6 million as of June 30, 2016, and consisted primarily of Chinese yuan, Hong Kong dollars, euros and Japanese yen.

Sources of cash are predominately from our deliveries of vehicles, as well as customer deposits for vehicles, sales of regulatory credits, proceeds from financing activities, sales of energy products, and non-warranty repair and maintenance services. We expect that our current sources of liquidity, including cash and cash equivalents, together with our current projections of cash flow from operating activities, will provide us with adequate liquidity based on our current plans through at least the end of the current fiscal year. These current sources of liquidity and cash flows enable us to fund our ongoing operations and research and development projects, the initial investments in tooling and manufacturing capital for our planned Model 3; the continued construction of our Gigafactory; and the expansion of our retail stores, service centers and Supercharger network. We have decided to advance our 500,000 total unit build plan by two years to 2018, which is approximately double our prior growth plan. Given this plan, we are currently in the process of evaluating our capital expenditure needs, but expect it will be approximately \$2.25 billion for the full year of 2016.

In 2015, we entered into the senior secured asset-based revolving Credit Agreement with a syndicate of banks. Our drawdowns are subject to certain conditions, including a borrowing limit of the lesser of (1) the current total commitment amount of \$1 billion and (2) the value of the secured assets as determined monthly pursuant to the Credit Agreement. As of June 30, 2016, the value of the secured assets was the limiting factor in our ability to borrow under the Credit Agreement. Borrowed funds bear interest, at the Company's option, at an annual rate of (a) 1% plus LIBOR or (b) the highest of (i) the federal funds rate plus 0.50%, (ii) the lenders "prime rate" or (iii) 1% plus LIBOR.

Subsequent to June 30, 2016, we have received additional outstanding conversion notices from holders of our 2018 Notes which require cash outlays to repay the principal portion of our 2018 Notes. The amount of notices received to date is for principal value of approximately \$411 million, which we expect to pay in the third quarter.

In addition, on July 31, 2016, we entered into a definitive agreement to acquire all outstanding common stock of SolarCity Corporation in exchange for Tesla common stock. Once the merger is completed, the operation of the combined company may require additional capital and could have an adverse impact on our results of operations and liquidity.

During the quarter ended June 30, 2016, we reached our funding limit with a banking partner where we received cash for the full price of the vehicles, which could adversely impact our liquidity and cash position. We anticipate adding new partners in the coming months.

When market conditions are favorable, we may evaluate alternatives to pursue liquidity options to fund capital intensive initiatives. Should prevailing economic, financial, business or other factors adversely affect our ability to meet our operating cash requirements, we could be required to obtain funding through traditional or alternative sources of financing. We cannot be certain that additional funds would be available to us on favorable terms when required, or at all.

We may also seek to refinance or restructure our existing debt, including our convertible senior notes, through exchanges, repurchases, redemptions and conversions. During the third quarter, we will be using substantial amounts of cash in connection with conversions of our 2018 Notes and we could pursue other actions to reduce our outstanding balance of convertible notes, which could require further outlays of cash. Our inability to raise additional funds or to refinance or restructure our existing debt could have an adverse effect on our business.

Summary of Cash Flows (in thousands)

	Six Months Ended June 30,	
	2016	2015
Net cash used in operating activities	\$ (99,269)	\$ (291,310)
Net cash used in investing activities	(553,673)	(855,181)
Net cash provided by financing activities	2,692,019	404,507

Cash Flows from Operating Activities

Our cash flows from operating activities are significantly affected by our cash investments to support the growth of our business in areas such as manufacturing, research and development and selling, general and administrative. Our operating cash flows are also affected by our working capital needs to support growth and fluctuations in inventory, personnel related expenditures, accounts payable and other current assets and liabilities.

Our operating cash inflows include cash from sales of our vehicles, customer deposits for vehicles, including Model 3, sales of regulatory credits, sales of powertrain components and systems, and energy products. These cash inflows are offset by payments we make to our suppliers for production materials and parts used in our manufacturing process, employee compensation, operating leases and interest expense on our financings.

During the six months ended June 30, 2016 and 2015, cash used in operating activities was \$99.3 million and \$291.3 million. The increase in operating cash flows for the six months ended June 30, 2016 compared to comparable period in 2015 was primarily due to an increase in proceeds from vehicle sales, including those with residual value guarantees, proceeds from customer deposits for vehicles and increase in accounts payable and accrued liabilities, partially offset by an increase in inventory and operating lease vehicles.

Cash Flows from Investing Activities

Cash flows from investing activities primarily relate to capital expenditures to support our growth in operations, including investments in Model S and Model X manufacturing equipment and tooling, the continued construction of our Gigafactory, and our stores, service centers and Supercharger network infrastructure. Cash used in investing activities was \$553.7 million and \$855.2 million for the six months ended June 30, 2016 and 2015. Cash flows from investing activities and variability between each year related primarily to capital expenditures, which were \$511.6 million and \$831.2 million for the six months ended June 30, 2016 and 2015.

In 2014, we began construction of our Gigafactory facility in Nevada. Tesla's contribution to total capital expenditures are expected to be about \$2.0 billion. In the six months ended June 30, 2016 we used cash of \$117.4 million towards Gigafactory construction and expect to spend a total of approximately \$520.0 million during 2016.

Cash Flows from Financing Activities

During the six months ended June 30, 2016 and 2015, net cash provided by financing activities was \$2.69 billion and \$404.5 million. Cash flows from financing activities during the six months ended June 30, 2016 consisted primarily of \$1.7 billion net proceeds from our May 2016 public offering of 7,915,004 shares of common stock, net draws under our asset based credit agreement of \$543.0 million and proceeds received from vehicle sales to our bank leasing partners of \$384.5 million. Cash flows from financing activities during the six months ended June 30, 2015 consisted primarily of proceeds received from vehicle sales to our bank leasing partners of \$196.5 million and draws under our asset backed or warehouse credit lines of \$168.2 million.

0.25% and 1.25% Convertible Senior Notes and Bond Hedge and Warrant Transactions

In 2014, we issued \$920.0 million principal amount of 0.25% convertible senior notes due 2019 (2019 Notes) and \$1.38 billion principal amount of 1.25% convertible senior notes due 2021 (2021 Notes) in a public offering. The total net proceeds from these offerings, after deducting transaction costs, were approximately \$905.8 million from 2019 Notes and \$1.36 billion from 2021 Notes. The interest rates are fixed at 0.25% and 1.25% per annum for the 2019 and 2021 Notes and are payable semi-annually in arrears on March 1 and September 1 of each year, commencing on September 1, 2014.

In connection with the offering of these notes in 2014, we purchased convertible note hedges for an aggregate \$603.4 million and sold warrants for an aggregate \$389.2 million. Taken together, the purchase of the convertible note hedges and the sale of warrants are intended to reduce potential dilution and/or offset potential cash payments upon the conversion of the 2019 Notes and 2021 Notes.

During the second quarter of 2016, the closing price of our common stock did not meet or exceed 130% of the applicable conversion price of our 2019 Notes and 2021 Notes on at least 20 of the last 30 consecutive trading days of the quarter; furthermore, no other conditions allowing holders of these notes to convert have been met as of June 30, 2016. Therefore, the 2019 Notes and 2021 Notes are not convertible during the third quarter of 2016 and are classified as long-term debt. Should the closing price conditions be met in the third quarter of 2016 or a future quarter, the 2019 Notes and/or the 2021 Notes will be convertible at their holders' option during the immediately following quarter.

1.50% Convertible Senior Notes and Bond Hedge and Warrant Transactions

In May 2013, we issued \$660.0 million aggregate principal amount of 1.50% convertible senior notes due 2018 (the 2018 Notes) in a public offering. The net proceeds from the offering, after deducting transaction costs, were approximately \$648.0 million. The interest under the 2018 Notes is fixed at 1.50% per annum and is payable semi-annually in arrears on June 1 and December 1 of each year, commencing on December 1, 2013.

In connection with the offering of the 2018 Notes, we purchased convertible note hedges for an aggregate \$177.5 million and sold warrants for an aggregate \$120.3 million. Taken together, the purchase of the convertible note hedges and the sale of warrants are intended to reduce potential dilution and/or offset potential cash payments upon the conversion of the 2018 Notes.

During the second quarter of 2016, the closing price of our common stock exceeded 130% of the applicable conversion price of our 2018 Notes on at least 20 of the last 30 consecutive trading days of the quarter; therefore, holders of 2018 Notes may convert their notes during the third quarter of 2016. As such, we classified the \$608.9 million carrying value of our 2018 Notes as current liabilities and classified \$37.1 million, representing the difference between the aggregate principal of our 2018 Notes of \$646.1 million and the carrying value of 2018 Notes, as mezzanine equity on our consolidated balance sheet as of June 30, 2016. Should the closing price conditions be met again in the third quarter of 2016 or a future quarter, the 2018 Notes will be convertible at their holders' option during the immediately following quarter. For the six months ended June 30, 2016, we paid a total of \$13.9 million related to conversions of the 2018 Notes at the request of the holders. Subsequent to June 30, 2016, we received additional conversion requests for principal value of approximately \$411 million.

For more information on the 2018 Notes, 2019 Notes, and 2021 Notes see Note 8 to our Consolidated Financial Statements included under Part 1, Item 1 of this Quarterly Report on Form 10-Q.

Contractual Obligations

We are party to contractual obligations involving commitments to make payments to third parties, including certain debt financing arrangements and leases, primarily for stores, service centers, certain manufacturing and corporate offices. These also include, as part of our normal business practices, contracts with suppliers for purchases of certain raw materials, components, and services to facilitate adequate supply of these materials and services and capacity reservation contracts.

Subsequent to June 30, 2016, we have received additional conversion notices from certain holders for our 2018 Notes which require cash outlays to repay the principal portion of our 2018 Notes. The total amount of notices received to date is for principal value of approximately \$411 million, which we expect to pay during the third quarter.

There have been no material changes during the six months ended June 30, 2016, from the contractual obligations disclosed in Part II, Item 7, *Contractual Obligations*, of our Annual Report on Form 10-K for the year ended December 31, 2015.

Off-Balance Sheet Arrangements

During the periods presented, we did not have relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Risk

We transact business globally in multiple currencies. Our international revenues, as well as costs and expenses denominated in foreign currencies, expose us to the risk of fluctuations in foreign currency exchange rates against the functional currencies of our foreign subsidiaries and against the U.S. dollar. Upon consolidation, as foreign exchange rates vary, revenues and expenses may be significantly impacted and we may record significant gains or losses on the remeasurement of monetary assets and liabilities, including intercompany balances. As of June 30, 2016, our largest currency exposures are from the euro, Chinese yuan, Hong Kong dollars, euros and Japanese yen. We recorded foreign exchange gains of \$0.8 million in other income (expense), net, for the six months ended June 30, 2016 related to the impact of changes in exchange rates on foreign currency denominated monetary assets and liabilities.

We considered the historical trends in currency exchange rates and determined that it was reasonably possible that adverse changes in exchange rates of 10% for all currencies could be experienced in the near term. These reasonably possible adverse changes in exchange rates of 10% were applied to total monetary assets and liabilities denominated in currencies other than the functional currencies as of June 30, 2016 to compute the adverse impact these changes would have had on our income before income taxes in the near term. These changes would have resulted in an adverse impact on income before income taxes of approximately \$294.5 million, recorded to other income (expense), net, principally from intercompany and cash balances.

In November 2015, we implemented a program to hedge the foreign currency exposure risk related to certain forecasted inventory purchases denominated in Japanese yen. The derivative instruments we use are foreign currency forward contracts and are designated as cash flow hedges with maturity dates of 12 months or less. We do not enter into derivative contracts for trading or speculative purposes. We document each hedge relationship and assess its initial effectiveness at the inception of the hedge contract and we measure its ongoing effectiveness on a quarterly basis using regression analysis. During the term of an effective hedge contract, we record gains and losses within accumulated other comprehensive loss. We reclassify these gains or losses to costs of automotive sales in the period the related finished goods inventory is sold or over the depreciation period for those sales accounted for as leases. Although our contracts are considered effective hedges, we may experience small amounts of ineffectiveness due to timing differences between our actual inventory purchases and the settlement date of the related foreign currency forward contracts. Ineffectiveness related to the hedges is immaterial as of June 30, 2016. As of June 30, 2016 we had recorded a cumulative gain of \$38.3 million to AOCI related to our outstanding foreign currency cash flow hedges. If the U.S. dollar had strengthened by 10% as of June 30, 2016, the gain recorded in AOCI related to our cumulative foreign exchange contracts before tax effect would have been reduced by approximately \$22.4 million.

Interest Rate Risk

We had cash and cash equivalents totaling \$3.25 billion as of June 30, 2016. A significant portion of our cash and cash equivalents were invested in money market funds. Cash and cash equivalents are held for working capital purposes. We do not enter into investments for trading or speculative purposes. We believe that we do not have any material exposure to changes in the fair value as a result of changes in interest rates due to the short term nature of our cash equivalents.

As of June 30, 2016, we had \$2.95 billion aggregate principal amount of convertible senior notes outstanding, which are fixed rate instruments. Therefore, our results of operations are not subject to fluctuations in interest rates. However, the fair value of our debt will fluctuate with movements of interest rates, increasing in periods of declining rates of interest and declining in periods of increasing rates of interest. Based upon quoted market prices and Level 2 inputs, the fair value of our total debt was \$3.02 billion as of June 30, 2016.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our chief executive officer and chief financial officer, evaluated the effectiveness of our disclosure controls and procedures as of June 30, 2016. The term “disclosure controls and procedures,” as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company’s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Based on the evaluation of our disclosure controls and procedures as of June 30, 2016, our chief executive officer and chief financial officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving their objectives and management necessarily applies its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting which occurred during the period covered by this Quarterly Report on Form 10-Q, which has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Securities Litigation

In November 2013, a putative securities class action lawsuit was filed against Tesla in U.S. District Court, Northern District of California, alleging violations of, and seeking remedies pursuant to, Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5. The complaint made claims against Tesla and our CEO, Elon Musk, sought damages and attorney's fees on the basis of allegations that, among other things, Tesla and Mr. Musk made false and/or misleading representations and omissions, including with respect to the safety of Model S. This case was brought on behalf of a putative class consisting of certain persons who purchased Tesla's securities between August 19, 2013 and November 17, 2013. On September 26, 2014, the trial court, upon the motion of Tesla and Mr. Musk, dismissed the complaint with prejudice, and thereafter issued a formal written order to that effect. The plaintiffs have appealed from the trial court's order, and that appeal is pending.

Other Matters

From time to time, we have received requests for information from regulators and governmental authorities, such as the National Highway Traffic Safety Administration, the National Transportation Safety Board and the Securities and Exchange Commission. We are also subject to various other legal proceedings that arise from the normal course of business activities. In addition, from time to time, third parties may assert intellectual property infringement claims against us in the form of letters and other forms of communication. If an unfavorable ruling were to occur, there exists the possibility of a material adverse impact on our results of operations, prospects, cash flows, financial position and brand.

ITEM 1A. RISK FACTORS

You should carefully consider the risks described below together with the other information set forth in this report, which could materially affect our business, financial condition and future results. The risks described below are not the only risks facing our company. Risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and operating results.

Risks Related to Our Business and Industry

We have experienced in the past, and may experience in the future, significant delays or other complications in the design, manufacture, launch and production ramp of new vehicles and other products such as our energy products, which could harm our brand, business, prospects, financial condition and operating results.

We have experienced delays or other complications in connection with new vehicle models in the past, such as production ramp delays for Model S in 2012 and the All-Wheel Drive Dual Motor Model S, and the launch and ramp of Model X. For example, while we commenced Model X deliveries late in the third quarter of 2015, we encountered unanticipated challenges, such as certain supply chain constraints, in ramping production of Model X vehicles that forced us to decrease the production of these vehicles from our initial expectations. If these challenges recur or other unexpected issues arise, we may experience further delays in the Model X production ramp. In addition, since Model X shares certain production facilities with the Model S, the volume or efficiency of Model S production may be impacted by any Model X production ramp issues.

We may experience similar delays or other complications in bringing to market and ramping production of new vehicles, such as Model 3, and other products such as our energy products. Any significant additional delay or other complication in the production of our current products or the development, manufacture, launch and production ramp of our future products, including complications associated with expanding our production capacity, supply chain or regulatory approvals, could materially damage our brand, business, prospects, financial condition and operating results.

We may experience delays in realizing our projected timelines and cost and volume targets for the production, launch and ramp of our Model 3 vehicle, which could harm our business, prospects, financial condition and operating results.

Our future business depends in large part on our ability to execute on our plans to develop, manufacture, market and sell the Model 3 vehicle, which we intend to offer at a lower price point and to produce at significantly higher volumes than our present production capabilities for the Model S or Model X vehicles. We unveiled a prototype of Model 3 in March 2016 and have announced our goal to achieve volume production and deliveries of this vehicle in late 2017.

We have no experience to date in manufacturing vehicles at the high volumes that we anticipate for Model 3, and to be successful, we will need to develop efficient, automated, low-cost manufacturing capabilities, processes and supply chains necessary to support such volumes. Additionally, plans for the design and build out of our production facilities for Model 3 are still in process, and various aspects of the Model 3 component procurement and manufacturing plans are still being determined. We are currently evaluating, qualifying and selecting some of our suppliers for the planned production of Model 3. We will also need to do extensive testing to ensure that Model 3 is in compliance with our quality standards and applicable regulations prior to beginning mass production and delivery of the vehicles. Moreover, our Model 3 production plan will also require significant investments of cash and management resources.

Our production plan for Model 3 is based on many key assumptions, including:

- that we will be able to develop, build and equip a new dedicated final assembly line for high volume production of Model 3 at the Tesla Factory without exceeding our projected costs and on our projected timeline;
- that we will be able to build and bring online the Gigafactory in a timely manner to produce high volumes of quality lithium-ion cells and integrate such cells into finished battery packs for Model 3, all at costs that allow us to sell Model 3 at our target gross margins;
- that the equipment and processes which we select and install for Model 3 production will be able to accurately manufacture high volumes of Model 3 vehicles within specified design tolerances and with high quality;
- that we will be able to engage suppliers for the necessary components on terms and conditions acceptable to us and that we will be able to obtain components on a timely basis and in the necessary quantities to support high volume production;
- that we will be able to complete our final tooling, production planning and validation for Model 3 and deliver final component designs to our suppliers in a timely manner; and
- that we will be able to attract, recruit, hire and train skilled employees, including employees on the production line, to operate our planned high volume Model 3 production facilities at the Tesla Factory and the Gigafactory.

If one or more of the foregoing assumptions turns out to be incorrect, our ability to successfully launch Model 3 on time and at volumes and prices that are profitable, as well as our business, prospects, operating results and financial condition, may be materially and adversely impacted.

We may be unable to meet our growing vehicle production and delivery plans, both of which could harm our business and prospects.

Our plans call for significant increases in vehicle production and deliveries to high volumes in a short amount of time. Our ability to achieve these plans will depend upon a number of factors, including our ability to add production lines and capacity as planned while maintaining our desired quality levels and optimize design and production changes, and our suppliers' ability to support our needs. Due to the complexity of our supply chain, if we are unable to accurately match the timing and quantities of component purchases to our production plans, or change components or suppliers, we may have to incur unexpected costs to maintain, store and pay for components in excess of our needs or capabilities. We have limited experience developing, manufacturing, selling and servicing, and allocating our available resources among, multiple products simultaneously. If we are unable to realize our plans, or experience any delays or disruption in our production of our vehicles, our brand, business, prospects, financial condition and operating results could be materially damaged.

In addition, we have used and may use in the future a number of new manufacturing technologies, techniques and processes for our vehicles, which we must successfully introduce and scale for high volume production. For example, we have introduced aluminum spot welding systems and high-speed blow forming of certain difficult to stamp vehicle parts. Our vehicles also have unique design features, such as a 17 inch display screen, dual motor drivetrain and autopilot hardware introduced in Model S and falcon-wing doors and other unique features introduced in Model X, each of which poses different manufacturing challenges.

Concurrent with the significant planned increase in our vehicle production levels, we will also need to continue to significantly increase deliveries of our vehicles. We have limited experience in delivering a high volume of vehicles, and no experience in delivering vehicles at the significantly higher volumes we anticipate for Model 3, and we may face difficulties meeting our delivery and growth plans into both existing markets as well as new markets into which we expand. If we are unable to ramp up to meet our delivery goals globally, this could have a material adverse effect on our business, prospects, financial condition and operating results.

Our long-term success will be dependent upon our ability to achieve market acceptance of our vehicles, including Model S and Model X, and new vehicle models such as Model 3.

There is no guarantee that Model S, Model X or our future vehicles such as Model 3 will continue to be successfully accepted by the general public, especially in the long-term. Although we have successfully grown demand for Model S to date and have seen strong initial demand for Model X and Model 3, and we believe that we will be able to continue to grow demand for these vehicles, there is no guarantee that future demand for Model S, Model X or Model 3 will meet our expectations.

Additionally, we have limited experience in introducing new vehicles. Although our initial reservation conversion rate for Model X has been strong, we have only recently commenced production and deliveries of Model X. Likewise, although we have a substantial number of initial reservations for Model 3, we have only recently unveiled a prototype of Model 3 and do not expect to achieve volume production and deliveries of Model 3 until late 2017. To the extent that our Model X and Model 3 vehicles do not meet consumer expectations, our future sales could be harmed.

While we believe that there will continue to be separate and strong demand for each of our vehicles, we have limited experience in selling multiple vehicle models at the same time. Although we believe that each of our vehicles and their variants meet a distinct segment of the automotive market, if our vehicles in fact compete with one another in the market, then our ability to sell each vehicle model at planned quantities or prices may be impacted.

Problems or delays in bringing the Gigafactory online and operating it in line with our expectations could negatively affect the production and profitability of our products, such as Model 3 or energy products.

To lower the cost of cell production and produce cells in high volume, we intend to integrate the production of lithium-ion cells and finished battery packs for our vehicles, including Model 3, and energy products at our new Gigafactory. We have no direct experience in the production of lithium-ion cells. The cost and complexity of building and operating the Gigafactory could exceed our current expectations and the Gigafactory may take longer to bring online for lithium-ion cell and battery pack production than we anticipate or need. Also, our recently revised vehicle build plan includes an adjustment of our plans at the Gigafactory. In order to build our Model 3 vehicles at our planned volume and target gross margin, we must have significant battery cell production from our Gigafactory. If we are unable to complete building the Gigafactory in a timely manner, and attract, hire and retain a substantial number of highly skilled personnel to work there in order to produce high volumes of quality lithium-ion cells at reasonable prices, our ability to supply battery packs to our vehicles, especially Model 3, and other products according to our schedule and/or at a price that allows us to sell them at our target gross margins and in the quantities we estimate could be negatively impacted. Any such problems or delays with the Gigafactory could negatively affect our brand and harm our business, prospects, financial condition and operating results.

If our vehicles or other products that contain our vehicle powertrains or battery packs fail to perform as expected, our ability to develop, market and sell our electric vehicles could be harmed.

If our vehicles, vehicles that contain our powertrains or our energy products were to contain defects in design and manufacture that cause them not to perform as expected or that require repair, our ability to develop, market and sell our products could be harmed. For example, the operation of our vehicles is highly dependent on software, which is inherently complex and could conceivably contain defects and errors. Issues experienced by customers have included those related to the software for the 17 inch display screen, the panoramic roof and the 12 volt battery in the Model S and the seats and doors in the Model X. Although we attempt to remedy any issues we observe in our vehicles as effectively and rapidly as possible, such efforts may not be timely, may hamper production or may not be up to the satisfaction of our customers. While we have performed extensive internal testing, we currently have a limited frame of reference by which to evaluate detailed long-term quality, reliability, durability and performance characteristics of our battery packs, powertrains, vehicles and energy products. There can be no assurance that we will be able to detect and fix any defects in our products prior to their sale to consumers.

Any product defects or any other failure of our products to perform as expected could harm our reputation and result in delivery delays, product recalls, product liability claims, significant warranty and other expenses, and could have a material adverse impact on our business, financial condition, operating results and prospects. Our Model X vehicles have not yet been evaluated by NHTSA for a star rating under the New Car Assessment Program, and while based on our internal testing we expect to obtain comparable ratings to those achieved by Model S, there is no assurance this will occur.

We are dependent on our suppliers, the majority of which are single source suppliers, and the inability of these suppliers to deliver, or their refusal to deliver, necessary components of our vehicles in a timely manner at prices, quality levels, and volumes acceptable to us could have a material adverse effect on our financial condition and operating results.

Our current products contain numerous purchased parts which we source globally from hundreds of direct suppliers, the majority of whom are currently single source suppliers despite efforts to qualify and obtain components from multiple sources whenever feasible. Furthermore, we do not maintain long-term agreements with a number of our suppliers. This limited supply chain exposes us to multiple potential sources of delivery failure or component shortages for the production of our products. We have experienced in the past and may experience in the future delays due to supply chain disruptions with respect to our current products and future products we may produce, such as those we have experienced in 2012 and 2016 in connection with our slower-than-planned Model S and Model X ramps.

Unexpected changes in business conditions, materials pricing, labor issues, wars, governmental changes, natural disasters such as the March 2011 earthquakes in Japan and other factors beyond our and our suppliers' control, could also affect our suppliers' ability to deliver components to us on a timely basis. Moreover, any significant unanticipated demand may require us to procure additional components in a short amount of time, and in the past we have also replaced certain suppliers because of their failure to provide components that met our quality control standards. While we believe that we will be able to secure additional or alternate sources of supply for most of our components in a relatively short time frame, there is no assurance that we will be able to do so or develop our own replacements for certain highly customized components of our vehicles. The loss of any single or limited source supplier or the disruption in the supply of components from these suppliers could lead to vehicle design changes and delays in vehicle deliveries to our customers, which could hurt our relationships with our customers and result in negative publicity, damage to our brand and a material and adverse effect on our business, prospects, financial condition and operating results.

Changes in our supply chain have also resulted in the past, and may result in the future, in increased cost. We have also experienced cost increases from certain of our suppliers in order to meet our quality targets and development timelines as well as due to design changes that we made, and we may experience similar cost increases in the future. Certain suppliers, including for Model X, have experienced delays in meeting our demand or quality requirements, or have sought to renegotiate the terms of the supply arrangements. Additionally, we are negotiating with existing suppliers for cost reductions, seeking new and less expensive suppliers for certain parts, and attempting to redesign certain parts to make them less expensive to produce. If we are unsuccessful in our efforts to control and reduce supplier costs, our operating results will suffer.

Moreover, we have signed an agreement with Panasonic to be our partner in the Gigafactory and be responsible for, among other things, manufacturing cells from there for use in our products. If we encounter unexpected difficulties with our current suppliers, including Panasonic, and if we are unable to fill these needs from other suppliers, we could experience production delays and potential loss of access to important technology and parts for producing, servicing and supporting our products, which could have a material adverse effect on our financial condition and operating results.

We expect the foregoing discussion to apply generally to Model 3. However, because we plan to produce Model 3 at significantly higher volumes than Model S or Model X, the negative impact of any delays or other constraints with respect to our suppliers for Model 3 could be substantially greater than any such issues experienced with respect to Model S, Model X or our energy products. As some of our current suppliers may not have the resources, equipment or scalability to provide components for the Model 3 in line with our requirements, we may need to engage a significant number of new suppliers with whom we have relatively little or no experience, and such suppliers may have to ramp to achieve our needs in a short period of time. There is no assurance that these suppliers will ultimately be able to meet our cost, quality and volume needs.

Our future growth is dependent upon consumers' willingness to adopt electric vehicles, especially in the mass market demographic which we are targeting with Model 3.

Our growth is highly dependent upon the adoption by consumers of alternative fuel vehicles in general and electric vehicles in particular, especially in the mass market demographic which we are targeting with Model 3.

If the market for electric vehicles in general and Tesla vehicles in particular does not develop as we expect, or develops more slowly than we expect, our business, prospects, financial condition and operating results will be harmed. The market for alternative fuel vehicles is relatively new, rapidly evolving, and could be affected by numerous external factors, such as:

- perceptions about electric vehicle features, quality, safety, performance and cost;
- perceptions about the limited range over which electric vehicles may be driven on a single battery charge;

- competition, including from other types of alternative fuel vehicles, plug-in hybrid electric vehicles, and high fuel-economy internal combustion engine vehicles;
- volatility in the cost of oil and gasoline;
- government regulations and economic incentives; and
- access to charging facilities.

If we fail to scale our business operations and otherwise manage future growth effectively as we rapidly grow our company, especially internationally, we may not be able to produce, market, sell and service our products successfully.

Any failure to manage our growth effectively could materially and adversely affect our business, prospects, operating results and financial condition. We continue to expand our operations significantly, especially internationally, including by a planned transition to high volume vehicle production and the worldwide sales and servicing of a significantly higher number of vehicles than our current vehicle fleet in the coming years, with the launch and ramp of Model 3. Furthermore, we are developing and growing our energy product business worldwide, including in countries where we have limited or no previous operating experience in connection with our vehicle business. Our future operating results depend to a large extent on our ability to manage our expansion and growth successfully. We may not be successful in undertaking this global expansion if we are unable to control expenses and avoid cost overruns and other unexpected operating costs; establish sufficient worldwide sales, service and Supercharger facilities in a timely manner; adapt our products to meet local requirements; implement the required infrastructure, systems and processes; and find and hire a significant number of additional manufacturing, engineering, service and administrative personnel.

If we are unable to continue to reduce the manufacturing costs of Model S and Model X or control manufacturing costs for Model 3, our financial condition and operating results will suffer.

As we have gradually ramped production of Model S, manufacturing costs per vehicle have decreased, and we anticipate similar decreases in the manufacturing costs of Model X as we continue to ramp production of that vehicle. While we expect ongoing cost reductions to be realized by both us and our suppliers, there is no guarantee we will be able to achieve sufficient cost savings to reach our gross margin and profitability goals. We incur significant costs related to procuring the raw materials required to manufacture our vehicles, assembling vehicles and compensating our personnel. We may also incur substantial costs or cost overruns in increasing the production capability of our vehicle manufacturing facilities, such as for Model 3. Furthermore, if we are unable to achieve production cost targets on our Model X and Model 3 vehicles pursuant to our plans, we may not be able to meet our gross margin and other financial targets.

Furthermore, many of the factors that impact our manufacturing costs are beyond our control, such as potential increases in the costs of our raw materials and components, such as lithium-ion battery cells or aluminum used to produce body panels. If we are unable to continue to control and reduce our manufacturing costs, our operating results, business and prospects will be harmed.

Although we are significantly dependent upon revenue generated from the sale of the Model S and Model X in the near term, our future success will be dependent upon our ability to design and achieve market acceptance of Model 3 and future vehicles with broad public appeal.

We currently generate a significant percentage of our revenues from the sale of our Model S and Model X vehicles. The Model 3, for which we are planning to achieve volume production and deliveries in late 2017, requires significant investment prior to commercial introduction, and there is no guarantee that it will be commercially successful. The market for vehicles in the price range we expect for Model 3 is larger, but more competitive, than the markets for Model S and Model X. There can be no assurance that Model 3 or our future electric vehicles will meet the expectations of our customers or of a broad customer base. To the extent that we are not able to build the production Model 3 to the expectations created by the prototype we unveiled in March 2016, including the announced vehicle specifications and cost to customers, customers may cancel their reservations, our future sales could be harmed and investors may lose confidence in us. Furthermore, historically, automobile customers have come to expect new and improved vehicle models to be introduced frequently. In order to meet these expectations, we may in the future be required to introduce on a regular basis new vehicle models as well as enhanced versions of existing vehicle models. To the extent our product cycles do not meet consumer expectations, our future sales may be adversely affected.

Reservations for Model 3 may be cancelled prior to their sale and are fully refundable to customers, and significant cancellations could harm our financial condition, business, prospects and operating results.

We have received a significant number of reservations for Model 3, all of which are subject to customer cancellations up until such time that the customer enters into a purchase agreement. As Model 3 will have a significantly lower price point than our previous vehicles and we do not expect to achieve volume production and deliveries of Model 3 before late 2017, we will for a lengthy period of time be subject to a number of factors that may result in cancellations of these reservations, including potential changes in customer financial position and preferences, competitive developments, and any unanticipated deviations from the expected price point, vehicle features or performance characteristics. There can be no assurance that any reservation will ultimately result in the sale of a vehicle, or that our number of reservations at any given time will accurately reflect the future demand for and sales of the Model 3. Furthermore, all amounts received by us in connection with reservations taken prior to the ramp of our vehicles have historically been refundable. Given the substantial number of Model 3 reservations, significant cancellations could harm our financial condition, business, prospects and operating results.

We may fail to meet our publicly announced guidance or other expectations about our business, which could cause our stock price to decline.

We occasionally provide guidance regarding our expected financial and business performance, such as projections regarding sales and production, as well as anticipated future revenues, gross margins, profitability and cash flows. Correctly identifying key factors affecting business conditions and predicting future events is inherently an uncertain process and our guidance may not ultimately be accurate. Our guidance is based on certain assumptions such as those relating to anticipated production and sales volumes and average sales prices, supplier and commodity costs, and planned cost reductions. If our guidance is not accurate or varies from actual results due to our inability to meet our assumptions or the impact on our financial performance that could occur as a result of various risks and uncertainties, the market value of our common stock could decline significantly.

Our vehicles make use of lithium-ion battery cells, which have been observed to catch fire or vent smoke and flame, and such events have raised concerns, and future events may lead to additional concerns, about the batteries used in automotive applications.

The battery packs that we produce make use of lithium-ion cells. On rare occasions, lithium-ion cells can rapidly release the energy they contain by venting smoke and flames in a manner that can ignite nearby materials as well as other lithium-ion cells.

While we have designed the battery pack to passively contain any single cell's release of energy without spreading to neighboring cells, there can be no assurance that a field or testing failure of our vehicles or other battery packs that we produce will not occur, which could subject us to lawsuits, product recalls, or redesign efforts, all of which would be time consuming and expensive. Also, negative public perceptions regarding the suitability of lithium-ion cells for automotive applications or any future incident involving lithium-ion cells such as a vehicle or other fire, even if such incident does not involve our vehicles, could seriously harm our business.

In addition, we store a significant number of lithium-ion cells at the Tesla Factory and plan to produce high volumes of cells and battery modules and packs at our Gigafactory. Any mishandling of battery cells may cause disruption to the operation of our facilities. While we have implemented safety procedures related to the handling of the cells, there can be no assurance that a safety issue or fire related to the cells would not disrupt our operations. Such damage or injury could lead to adverse publicity and potentially a safety recall. Moreover, any failure of a competitor's electric vehicle or energy product may cause indirect adverse publicity for us and our products. Such adverse publicity could negatively affect our brand and harm our business, prospects, financial condition and operating results.

We are exposed to fluctuations in currency exchange rates, which could negatively affect our financial results.

Our revenues and costs denominated in foreign currencies are not completely matched. As we have increased Model S deliveries in markets outside of the United States, we have much higher revenues than costs denominated in other currencies such as the euro, Chinese renminbi, Norwegian kroner, British pound and Canadian dollar. Any strengthening of the U.S. dollar would tend to reduce our revenues as measured in U.S. dollars, as we have historically experienced. In addition, a portion of our costs and expenses have been, and we anticipate will continue to be, denominated in foreign currencies, including the Japanese yen. If we do not have fully offsetting revenues in these currencies and if the value of the U.S. dollar depreciates significantly against these currencies, our costs as measured in U.S. dollars as a percent of our revenues will correspondingly increase and our margins will suffer. Moreover, while we undertake limited hedging activities intended to offset the impact of currency translation exposure, it is impossible to predict or eliminate such impact. As a result, our operating results could be adversely affected.

Our resale value guarantee and leasing programs for our vehicles expose us to the risk that the resale values of vehicles returned to us are lower than our estimates and may result in lower revenues, gross margin, profitability and liquidity.

We have provided resale value guarantees to many of our customers, under which such customers may sell their vehicles back to us at certain points in time at pre-determined resale values. Customers can lease our vehicles through both leasing partners and from us directly, through our captive finance companies. The resale values of any vehicles resold or returned to us pursuant to these programs may be lower than our estimates, which are based on a limited secondary market for our vehicles. If the volume of vehicles returned to us is higher than our estimates and/or we are not able to resell them timely or at all, our liquidity could be negatively impacted. In cases where customers retain their vehicles past the guarantee period, our gross margin will be negatively impacted as all remaining revenues and costs related to the vehicle will be recognized at no gross profit.

We apply lease accounting on sales of vehicles with a resale value guarantee and on leases made directly by us or by our leasing partners. Under lease accounting, we recognize the associated revenues and costs of the vehicle sale over time rather than fully upfront at vehicle delivery. As a result, these programs generate lower revenues in the period the car is delivered and higher gross margins during the period of the resale value guarantee as compared to purchases in which the resale value guarantee does not apply. A higher than anticipated prevalence of these programs could therefore have an adverse impact on our near term revenues and operating results. Moreover, unlike the sale of a vehicle with a resale value guarantee or programs with leasing partners which do not impact our cash flows and liquidity at the time of vehicle delivery, under a lease held directly by us, we may receive only a very small portion of the total vehicle purchase price at the time of lease, followed by a stream of payments over the term of the lease. To the extent we expand our leasing program without securing external financing or business partners to support such expansion, our cash flow and liquidity could also be negatively impacted.

If we fail to effectively grow and manage the residual, financing and credit risks related to our direct vehicle leasing programs, our business may suffer.

We offer vehicle financing arrangements through our local subsidiaries in the United States, Canada, Germany and the UK, including leasing directly through certain of those subsidiaries. The profitability of the leasing program depends on our ability to accurately project residual values, secure adequate financing and/or business partners to fund and grow this program, and manage customer credit risk. If actual residual values of our vehicles are below our estimates, we may suffer lower profitability or potentially have losses. If we are unable to adequately fund our leasing program with internal funds, or partners or other external financing sources, and compelling alternative financing programs are not available for our customers, we may be unable to grow our sales. For example, in certain cases purchasing lease contracts from us is at the discretion of our partners and there is no guarantee that our partners will accept such contracts at the volumes and times requested by us. Additionally, if we do not properly screen customers for their creditworthiness, we may be exposed to excessive credit risks and associated losses. Furthermore, if our leasing business grows substantially, our business may suffer if we cannot effectively manage the greater levels of residual and credit risks resulting from growth. Finally, if we do not successfully monitor and comply with applicable national, state and/or local financial regulations and consumer protection laws governing lease transactions, we may become subject to enforcement actions or penalties, either of which may harm our business.

Increases in costs, disruption of supply or shortage of raw materials, in particular for lithium-ion cells, could harm our business.

We may experience increases in the cost or a sustained interruption in the supply or shortage of raw materials. Any such increase, supply interruption or shortage could materially and negatively impact our business, prospects, financial condition and operating results. We use various raw materials in our business including aluminum, steel, nickel and copper. The prices for these raw materials fluctuate depending on market conditions and global demand for these materials and could adversely affect our business and operating results. For instance, we are exposed to multiple risks relating to lithium-ion cells. These risks include:

- the inability or unwillingness of current battery manufacturers to build or operate battery cell manufacturing plants to supply the numbers of lithium-ion cells we require;
- disruption in the supply of cells due to quality issues or recalls by battery cell manufacturers;
- an increase in the cost of raw materials used in the cells; and
- fluctuations in the value of the Japanese yen against the U.S. dollar as our battery cell purchases for Model S and Model X are currently denominated in Japanese yen.

Our business is dependent on the continued supply of battery cells for the battery packs used in our vehicles and energy products. While we believe several sources of the battery cells are available for such battery packs, we have fully qualified only a very limited number of suppliers for the cells used in such battery packs and have very limited flexibility in changing cell suppliers. In particular, we have fully qualified only one supplier for the cells used in battery packs for our production vehicles. Any disruption in the supply of battery cells from such vendors could disrupt production of our vehicles and of the battery packs we produce for other automobile manufacturers until such time as a different supplier is fully qualified. Furthermore, fluctuations or shortages in petroleum and other economic conditions may cause us to experience significant increases in freight charges and raw material costs. Substantial increases in the prices for our raw materials or prices charged to us, such as those charged by our battery cell manufacturers, would increase our operating costs, and could reduce our margins if we cannot recoup the increased costs through increased vehicle prices. Any attempts to increase vehicle prices in response to increased raw material costs could result in cancellations of vehicle orders and reservations and therefore materially and adversely affect our brand, image, business, prospects and operating results.

We may become subject to product liability claims, which could harm our financial condition and liquidity if we are not able to successfully defend or insure against such claims.

Product liability claims could harm our business, prospects, operating results and financial condition. The automobile industry experiences significant product liability claims and we face inherent risk of exposure to claims in the event our vehicles do not perform as expected resulting in personal injury or death. We also may face similar claims related to any misuse or failures of new technologies that we are pioneering, including autopilot in our vehicles and our energy products. A successful product liability claim against us could require us to pay a substantial monetary award. Our risks in this area are particularly pronounced given the limited number of vehicles and energy products delivered to date and limited field experience of our products. Moreover, a product liability claim could generate substantial negative publicity about our products and business and could have material adverse effect on our brand, business, prospects and operating results. We self-insure against the risk of product liability claims, meaning that any product liability claims will have to be paid from company funds, not by insurance.

The automotive market is highly competitive, and we may not be successful in competing in this industry. We currently face competition from new and established U.S. and international competitors and expect to face competition from others in the future, including competition from companies with new technology.

The worldwide automotive market, particularly for alternative fuel vehicles, is highly competitive today and we expect it will become even more so in the future. There is no assurance that our vehicles will be successful in the respective markets in which they compete. Many established and new automobile manufacturers such as BMW, Daimler, General Motors and Toyota, as well as other large companies, have entered or are reported to have plans to enter the alternative fuel vehicle market, including hybrid, plug-in hybrid and fully electric vehicles. Most of our current and potential competitors have significantly greater financial, technical, manufacturing, marketing and other resources than we do and may be able to devote greater resources to the design, development, manufacturing, distribution, promotion, sale and support of their products. Virtually all of our competitors have more extensive customer bases and broader customer and industry relationships than we do and almost all of these companies have longer operating histories and greater name recognition than we do. Increased competition could result in lower vehicle unit sales, price reductions, revenue shortfalls, loss of customers and loss of market share, which could harm our business, prospects, financial condition and operating results. In addition, upon the launch of our Model 3 vehicle, we will face competition from existing and future automobile manufacturers in the extremely competitive entry-level premium sedan market, including Audi, BMW, Lexus and Mercedes.

Demand in the automobile industry is volatile, which may lead to lower vehicle unit sales and adversely affect our operating results.

Volatility of demand in the automobile industry may materially and adversely affect our business, prospects, operating results and financial condition. The markets in which we currently compete and plan to compete in the future have been subject to considerable volatility in demand in recent periods. As a current low volume vehicle producer, we have less financial resources than more established automobile manufacturers to withstand changes in the market and disruptions in demand, and there is no guarantee that we will be able to successfully transition to a high volume producer with the production of the Model 3. Volatility in demand may lead to lower vehicle unit sales and increased inventory, which may result in further downward price pressure and adversely affect our business, prospects, financial condition and operating results. These effects may have a more pronounced impact on our business given our relatively smaller scale and financial resources as compared to many incumbent automobile manufacturers.

If we are unable to establish and maintain confidence in our long-term business prospects among consumers, analysts and within our industry, then our financial condition, operating results, business prospects and stock price may suffer materially.

Consumers may be less likely to purchase our products now if they are not convinced that our business will succeed or that our operations will continue for many years. Similarly, suppliers and other third parties will be less likely to invest time and resources in developing business relationships with us if they are not convinced that our business will succeed. Accordingly, in order to build and maintain our business, we must maintain confidence among customers, suppliers, analysts and other parties in our liquidity and long-term business prospects. Maintaining such confidence may be particularly complicated by certain factors, such as our limited operating history, unfamiliarity with our products, competition and uncertainty regarding the future of electric vehicles and our quarterly production and sales performance compared with market expectations. Many of these factors are largely outside our control, and any negative perceptions about our long-term business prospects, even if exaggerated or unfounded, would likely harm our business and make it more difficult to raise additional funds if needed.

Our vehicles have unique servicing requirements, and we are using a different service model from the one typically used in the automobile industry. If we are unable to address the service requirements of our existing and future customers, our business will be materially and adversely affected.

Servicing electric vehicles is different than servicing vehicles with internal combustion engines and requires specialized skills, including high voltage training and servicing techniques. If we are unable to satisfactorily service our vehicles, our ability to generate customer loyalty, grow our business and sell additional vehicles could be impaired.

We service our vehicles through our company-owned Tesla service centers, certain of our stores, and through our mobile service technicians known as the Tesla Rangers. We will need to accurately anticipate the need for and open new standalone service centers in locations around the world and hire and train significant numbers of new employees to staff these service centers and act as Tesla Rangers in order to successfully maintain our fleet of delivered vehicles. If we do not continue to adequately address the service requirements of our customers to their satisfaction, particularly as the volume of vehicles we are able to deliver annually increases, our business could be harmed.

Our plan to expand our network of Tesla stores and galleries, service centers and Superchargers will require significant cash investments and management resources and may not meet expectations with respect to additional sales of our electric vehicles or availability of Superchargers.

Our plan to expand our network of Tesla stores, galleries, service centers and Superchargers will require significant cash investments and management resources and may not meet our expectations with respect to additional sales of our vehicles. This ongoing global expansion, which includes planned entry into markets in which we have limited or no experience selling, delivering or servicing vehicles, and which may pose legal, regulatory, cultural and political challenges that we have not previously encountered, may not have the desired effect of increasing sales and expanding our brand presence to the degree we are anticipating. Furthermore, the increasing number of Model S and Model X vehicles, as well as the significant increase in our vehicle fleet size that we expect from Model 3, will require us to continue to increase the number our Supercharger stations significantly. If we fail to do so, our customers could become dissatisfied, which could adversely affect sales of our vehicles. We will also need to ensure we are in compliance with any regulatory requirements applicable to the sale and service of our vehicles and operation of Superchargers in those jurisdictions, which could take considerable time and expense. If we experience any delays or cannot meet customer expectations in expanding our network of Tesla stores, galleries, service centers and Superchargers, this could lead to a decrease in sales of our vehicles and could negatively impact our business, prospects, financial condition and operating results.

We face risks associated with our international operations and expansion, including unfavorable regulatory, political, tax and labor conditions and establishing ourselves in new markets, all of which could harm our business.

We currently have international operations and subsidiaries in various countries and jurisdictions that are subject to the legal, political, regulatory and social requirements and economic conditions in these jurisdictions. Additionally, as part of our growth strategy, we will continue to expand our sales, service and Supercharger locations internationally. We have limited experience, however, selling and servicing our products internationally, as well as limited experience installing and operating Superchargers internationally. Furthermore, international expansion requires us to make significant expenditures, including the establishment of local operating entities, hiring of local employees and establishing facilities in advance of generating any revenue.

We are subject to a number of risks associated with international business activities that may increase our costs, impact our ability to sell our electric vehicles and require significant management attention. These risks include conforming our vehicles to various international regulatory and safety requirements, difficulty in establishing, staffing and managing foreign operations, challenges in attracting customers, foreign government taxes, regulations and permit requirements, our ability to enforce our contractual rights; trade restrictions, customs regulations, tariffs and price or exchange controls, and preferences of foreign nations for domestically produced vehicles.

Additionally, as we have expanded into new international markets, we historically faced challenges with ensuring that our charging equipment works successfully with the charging infrastructure in such markets, including in Norway and China. If customers experience problems with the way our charging equipment works with the local charging infrastructure, or we are unable to adapt our equipment to resolve such problems, then the viability and acceptance of our vehicles in such markets could be materially and adversely affected. If we fail to successfully address these risks, our business, prospects, operating results and financial condition could be materially harmed.

The unavailability, reduction or elimination of government and economic incentives in the U.S. and abroad supporting the development and adoption of electric vehicles could have some impact on demand for our vehicles.

We currently benefit from certain government and economic incentives supporting the development and adoption of electric vehicles. In the United States and abroad, such incentives include, among other things, tax credits or rebates that encourage the purchase of electric vehicles. In Norway, for example, the purchase of electric vehicles is not currently subject to import taxes, taxes on non-recurring vehicle fees, the 25% value added tax or the purchase taxes that apply to the purchase of gas-powered vehicles. Notably, the quantum of incentive programs promoting electric vehicles is a tiny fraction of the amount of incentives that are provided to gas-powered vehicles through the oil and gas industries. Nevertheless, even the limited benefits from such programs could be reduced, eliminated or exhausted. For example, on January 1, 2016, a previously available incentive in Denmark that favored the purchase of electric vehicles expired and was replaced with a newly phased-in incentive that is less generous than the incentive that it replaced. Moreover, under current regulations, a \$7,500 federal tax credit available in the United States for the purchase of qualified electric vehicles with at least 17 kWh of battery capacity, such as our vehicles, will begin to phase out with respect to any vehicles delivered in the second calendar quarter following the quarter in which we deliver our 200,000th qualifying vehicle in the United States. In addition, California implemented regulations phasing out a \$2,500 cash rebate on qualified electric vehicles for high-income consumers, which became effective in March 2016. In certain circumstances, there is pressure from the oil and gas lobby or related special interests to bring about such developments, which could have some negative impact on demand for our vehicles.

If we are unable to attract and/or retain key employees and hire qualified personnel, our ability to compete could be harmed.

The loss of the services of any of our key employees could disrupt our operations, delay the development and introduction of our vehicles and services, and negatively impact our business, prospects and operating results. In particular, we are highly dependent on the services of Elon Musk, our Chief Executive Officer, and JB Straubel, our Chief Technical Officer.

None of our key employees is bound by an employment agreement for any specific term and we may not be able to successfully attract and retain senior leadership necessary to grow our business. Our future success depends upon our ability to attract and retain executive officers and other key technology, sales, marketing, engineering, manufacturing and support personnel and any failure to do so could adversely impact our business, prospects, financial condition and operating results.

Key talent may leave Tesla due to various factors, such as a very competitive labor market for talented individuals with automotive experience. Currently in California, there is increasing competition for talented individuals with the specialized knowledge of electric vehicles, software engineers, manufacturing engineers and other skilled employees. This competition affects both our ability to retain key employees and hire new ones. Our continued success depends upon our continued ability to hire new employees in a timely manner, especially to support our expansion plans and ramp to high-volume manufacture of vehicles, and retain current employees. Additionally, we compete with both mature and prosperous companies that have far greater financial resources than we do and start-ups and emerging companies that promise short-term growth opportunities. Difficulties in retaining current employees or recruiting new ones could have an adverse effect on our performance.

We are highly dependent on the services of Elon Musk, our Chief Executive Officer.

We are highly dependent on the services of Elon Musk, our Chief Executive Officer, Chairman of our Board of Directors and largest stockholder. Although Mr. Musk spends significant time with Tesla and is highly active in our management, he does not devote his full time and attention to Tesla. Mr. Musk also currently serves as Chief Executive Officer and Chief Technical Officer of Space Exploration Technologies, a developer and manufacturer of space launch vehicles, and Chairman of SolarCity, a solar provider.

We are subject to various environmental and safety laws and regulations that could impose substantial costs upon us and negatively impact our ability to operate our manufacturing facilities.

As an automobile manufacturer, we are subject to complex environmental, health and safety laws and regulations at numerous jurisdictional levels in the United States and abroad, including laws relating to the use, handling, storage, disposal and human exposure to hazardous materials. The costs of compliance, including remediating contamination if any is found on our properties and any changes to our operations mandated by new or amended laws, may be significant. We may also face unexpected delays in obtaining permits and approvals required by such laws in connection with our manufacturing facilities, which would hinder our operation of these facilities. Such costs and delays may adversely impact our business prospects and operating results. Furthermore, any violations of these laws may result in substantial fines and penalties, remediation costs, third party damages, or a suspension or cessation of our operations.

Our business may be adversely affected by any disruptions caused by union activities.

It is common for employees at automobile companies to belong to a union, which can result in higher employee costs and increased risk of work stoppages. Moreover, regulations in some jurisdictions outside of the United States mandate employee participation in industrial collective bargaining agreements and work councils with certain consultation rights with respect to the relevant companies' operations. Although we work diligently to provide the best possible work environment for our employees, they may still decide to join or seek recognition to form a labor union, or we may be required to become a union signatory. Furthermore, we are directly or indirectly dependent upon companies with unionized work forces, such as parts suppliers and trucking and freight companies, and work stoppages or strikes organized by such unions could have a material adverse impact on our business, financial condition or operating results. If a work stoppage occurs, it could delay the manufacture and sale of our products and have a material adverse effect on our business, prospects, operating results or financial condition.

Our vehicles are subject to substantial regulation, which is evolving, and unfavorable changes or failure by us to comply with these regulations could substantially harm our business and operating results.

Motor vehicles are subject to substantial regulation under international, federal, state, and local laws. We incur significant costs in complying with these regulations, and may be required to incur additional costs to comply with any changes to such regulations. We are subject to laws and regulations applicable to the import, sale and service of automobiles internationally. For example, in countries outside of the United States, we are required to meet vehicle-specific safety standards that are often materially different from U.S. requirements, thus resulting in additional investment into the vehicles and systems to ensure regulatory compliance in those countries. This process may include official review and certification of our vehicles by foreign regulatory agencies prior to market entry, as well as compliance with foreign reporting and recall management systems requirements.

Additionally, our vehicles are equipped with a range of autopilot features that assist drivers, relieving them of certain tedious and potentially dangerous aspects of road travel. Autopilot is a completely new feature with which U.S. and foreign regulators have limited experience. Any current or future proposed regulations in this area, if passed, could impact whether and how our customers are able to use our vehicles equipped for autopilot, and which, depending on the severity of the regulations, could adversely affect our business.

We are subject to various privacy and consumer protection laws.

Our privacy policy is posted on our website, and any failure by us or our vendor or other business partners to comply with it or with federal, state or international privacy, data protection or security laws or regulations could result in regulatory or litigation-related actions against us, legal liability, fines, damages and other costs. We may also incur substantial expenses and costs in connection with maintaining compliance with such laws, in particular data protection laws in the EU, which are currently in a state of transition. Although we take steps to protect the security of our customers' personal information, we may be required to expend significant resources to comply with data breach requirements if third parties improperly obtain and use the personal information of our customers or we otherwise experience a data loss with respect to customers' personal information. A major breach of our network security and systems could have negative consequences for our business and future prospects, including possible fines, penalties and damages, reduced customer demand for our vehicles, and harm to our reputation and brand.

We may be compelled to undertake product recalls or take other actions, which could adversely affect our brand image and financial performance.

Any product recall in the future may result in adverse publicity, damage our brand and adversely affect our business, prospects, operating results and financial condition. For example, we recently initiated a Model S recall in November 2015 after we discovered a single field unit with a front seat belt issue, and a Model X recall in April 2016 after an internal test revealed unintended movement in the third row seats during a collision. None of our past recalls have been related to our electric powertrain, and none of the underlying issues has resulted in a vehicle crash or personal injury reported to us. In the future, we may at various times, voluntarily or involuntarily, initiate a recall if any of our vehicles or our electric powertrain components that we provide to other OEMs, including any systems or parts sourced from our suppliers, prove to be defective or noncompliant with applicable federal motor vehicle safety standards. Such recalls, whether voluntary or involuntary or caused by systems or components engineered or manufactured by us or our suppliers, could involve significant expense and could adversely affect our brand image in our target markets, as well as our business, prospects, financial condition and results of operations.

Our current and future warranty reserves may be insufficient to cover future warranty claims which could adversely affect our financial performance.

If our warranty reserves are inadequate to cover future warranty claims on our vehicles, our business, prospects, financial condition and operating results could be materially and adversely affected. Warranty reserves include management's best estimate of the projected costs to repair or to replace items under warranty. These estimates are based on actual claims incurred to-date and an estimate of the nature, frequency and costs of future claims. These estimates are inherently uncertain and changes to our historical or projected experience may cause material changes to our warranty reserves in the future. Subject to separate limited warranties for the supplemental restraint system and battery, we provide four year or 50,000 mile limited warranties for the purchasers of new Model S and Model X vehicles and pre-owned Model S vehicles certified and sold by us. These limited warranties also cover the drive unit for eight years and the battery for a period of eight years or 125,000 miles or unlimited miles, depending on the size of the vehicle's battery and/or the date of delivery, although the battery's charging capacity is not covered under these warranties or any Extended Service plan.

In addition, customers of new Model S and Model X vehicles have the opportunity to purchase an Extended Service plan for the period after the end of the limited warranty for their new vehicles to cover additional services for an additional four years or 50,000 miles, provided it is purchased within a specified period of time. The limited warranties and Extended Service plans we offer for the Model S and Model X are subject to certain limitations, exclusions or separate warranties, including certain wear items, such as tires, brake pads, paint and general appearance, and battery performance, and is intended to cover parts and labor to repair defects in material or workmanship in the vehicle including the body, chassis, suspension, interior, electronic systems, powertrain and brake system. Additionally, in 2013, as part of our ongoing efforts to improve the customer ownership experience, we expanded the battery pack warranty and also eliminated the annual service requirement that was needed to keep the limited warranty on new Model S and Model X vehicles in effect. Should this change in warranty coverage lead to an increase in warranty claims, we may need to record additional warranty reserves, which would negatively affect our profitability.

We are currently expanding and improving our information technology systems and use security measures designed to protect our systems against breaches and cyber-attacks. If these efforts are not successful, our business and operations could be disrupted and our operating results and reputation could be harmed.

We are currently expanding and improving our information technology systems, including implementing new internally developed systems, to assist us in the management of our business. In particular, our volume production of multiple vehicles necessitates continued development, maintenance and improvement of our information technology systems in the U.S. and abroad, which include product data management, procurement, inventory management, production planning and execution, sales, service and logistics, dealer management, financial, tax and regulatory compliance systems. The implementation, maintenance and improvement of these systems require significant management time, support and cost. Moreover, there are inherent risks associated with developing, improving and expanding our core systems as well as implementing new systems, including the disruption of our data management, procurement, manufacturing execution, finance, supply chain and sales and service processes. These risks may affect our ability to manage our data and inventory, procure parts or supplies or manufacture, sell, deliver and service vehicles, or achieve and maintain compliance with, or realize available benefits under, tax laws and other applicable regulations. We also maintain information technology measures designed to protect us against system security risks, data breaches and cyber-attacks.

We cannot be sure that these systems or their required functionality will be effectively implemented, maintained or expanded as planned. If we do not successfully implement, maintain or expand these systems as planned, our operations may be disrupted, our ability to accurately and/or timely report our financial results could be impaired, and deficiencies may arise in our internal control over financial reporting, which may impact our ability to certify our financial results. Moreover, our proprietary information could be compromised and our reputation may be adversely affected. If these systems or their functionality do not operate as we expect them to, we may be required to expend significant resources to make corrections or find alternative sources for performing these functions.

Our insurance strategy may not be adequate to protect us from all business risks.

We may be subject, in the ordinary course of business, to losses resulting from products liability, accidents, acts of God and other claims against us, for which we may have no insurance coverage. While we currently maintain general liability, automobile, property, workers' compensation, and directors' and officers' insurance policies, as a general matter, we do not maintain as much insurance coverage as many other companies do, and in some cases, we do not maintain any at all. Additionally, the policies that we do have may include significant deductibles, and we cannot be certain that our insurance coverage will be sufficient to cover all future claims against us. A loss that is uninsured or which exceeds policy limits may require us to pay substantial amounts, which could adversely affect our financial condition and operating results.

Our financial results may vary significantly from period-to-period due to fluctuations in our operating costs.

We expect our period-to-period operating results to vary based on our operating costs which we anticipate will increase significantly in future periods as we, among other things, design, develop and manufacture Model 3, energy products and other future products, increase the production capacity at our manufacturing facilities to produce vehicles at higher volumes, including ramping up the production of Model X, develop the Gigafactory, open new Tesla service centers with maintenance and repair capabilities, open new Supercharger locations, increase our sales and marketing activities, and increase our general and administrative functions to support our growing operations. As a result of these factors, we believe that quarter-to-quarter comparisons of our operating results, especially in the short-term, are not necessarily meaningful and that these comparisons cannot be relied upon as indicators of future performance. Moreover, our operating results may not meet expectations of equity research analysts or investors. If any of this occurs, the trading price of our stock could fall substantially, either suddenly or over time.

Any unauthorized control or manipulation of our vehicles' systems could result in loss of confidence in us and our vehicles and harm our business.

Our vehicles contain complex information technology systems. For example, our vehicles are designed with built-in data connectivity to accept and install periodic remote updates from us to improve or update the functionality of our vehicles. We have designed, implemented and tested security measures intended to prevent unauthorized access to our information technology networks, our vehicles and their systems. However, hackers have reportedly attempted, and may attempt in the future, to gain unauthorized access to modify, alter and use such networks, vehicles and systems to gain control of, or to change, our vehicles' functionality, user interface and performance characteristics, or to gain access to data stored in or generated by the vehicle. We encourage reporting of potential vulnerabilities in the security of our vehicles via our security vulnerability reporting policy, and we aim to remedy any reported and verified vulnerabilities. Accordingly, we have received reports of potential vulnerabilities in the past and have attempted to remedy them. However, there can be no assurance that vulnerabilities will not be identified in the future, or that our remediation efforts are or will be successful.

Any unauthorized access to or control of our vehicles or their systems or any loss of data could result in legal claims or proceedings. In addition, regardless of their veracity, reports of unauthorized access to our vehicles, their systems or data, as well as other factors that may result in the perception that our vehicles, their systems or data are capable of being "hacked," could negatively affect our brand and harm our business, prospects, financial condition and operating results. We have been the subject of such reports in the past.

We may need or want to raise additional funds and these funds may not be available to us when we need them. If we cannot raise additional funds when we need or want them, our operations and prospects could be negatively affected.

The design, manufacture, sale and servicing of automobiles and energy products is a capital intensive business. Until we are consistently generating positive free cash flows, we may need or want to raise additional funds through the issuance of equity, equity-related or debt securities or through obtaining credit from financial institutions to fund, together with our principal sources of liquidity, the costs of developing and manufacturing our current or future vehicles and/or energy products, to pay any significant unplanned or accelerated expenses or for new significant strategic investments. We need sufficient capital to fund our ongoing operations, continue research and development projects, establish sales and service centers, build and deploy Superchargers, develop the Gigafactory and to make the investments in tooling and manufacturing capital required to introduce new vehicles and energy products. We cannot be

certain that additional funds will be available to us on favorable terms when required, or at all. If we cannot raise additional funds when we need them, our financial condition, results of operations, business and prospects could be materially and adversely affected.

We may face regulatory limitations on our ability to sell vehicles directly which could materially and adversely affect our ability to sell our electric vehicles.

We sell our vehicles from our Tesla stores as well as over the internet. We may not be able to sell our vehicles through this sales model in each state in the United States as some states have laws that may be interpreted to impose limitations on this sales model, including laws that prohibit manufacturers from selling vehicles directly to consumers without the use of an independent dealership or without a physical presence in the state. In certain states in which we are not able to obtain dealer licenses, we have opened galleries, which are not full retail locations.

The application of these state laws to our operations continues to be difficult to predict. Laws in some states have limited our ability to obtain dealer licenses from state motor vehicle regulators and may continue to do so.

In addition, decisions by regulators permitting us to sell vehicles may be subject to challenges as to whether such decisions comply with applicable state motor vehicle industry laws. For example, vehicle dealer associations in various states have filed lawsuits to revoke dealer licenses issued to us. We have prevailed in many of these lawsuits and such results have reinforced our continuing belief that state laws were not designed to prevent our distribution model. Possible additional challenges in other states, if successful, could restrict or prohibit our ability to sell our vehicles to residents in such states. In some states, there have also been regulatory and legislative efforts by vehicle dealer associations to propose bills and regulations that, if enacted, would prevent us from obtaining dealer licenses in their states given our current sales model. A few states have passed legislation that clarifies our ability to operate, but at the same time limits the number of dealer licenses we can obtain or stores that we can operate.

Internationally, there may be laws in jurisdictions we have not yet entered or laws we are unaware of in jurisdictions we have entered that may restrict our sales or other business practices. Even for those jurisdictions we have analyzed, the laws in this area can be complex, difficult to interpret and may change over time.

We may need to defend ourselves against patent or trademark infringement claims, which may be time-consuming and could cause us to incur substantial costs.

Others, including our competitors, may hold or obtain patents, trademarks or other proprietary rights that would prevent, limit or interfere with our ability to make, use, develop, sell or market our products and services, which could make it more difficult for us to operate our business. From time to time, we may receive communications from holders of patents or trademarks regarding their proprietary rights. Companies holding patents or other intellectual property rights may bring suits alleging infringement of such rights or otherwise assert their rights and urge us to take licenses. In addition, if we are determined to have infringed upon a third party's intellectual property rights, we may be required to cease making, selling or incorporating certain components or intellectual property into the goods and services we offer, pay substantial damages, seek a license, if available, from the holder of the infringed intellectual property right, redesign our products; and/or establish and maintain alternative branding for our products and services.

In the event that we were required to take one or more such actions, our business, prospects, operating results and financial condition could be materially adversely affected. In addition, any litigation or claims, whether or not valid, could result in substantial costs, negative publicity and diversion of resources and management attention.

Our facilities or operations could be damaged or adversely affected as a result of disasters.

Our corporate headquarters, the Tesla Factory and the Gigafactory are located in seismically active regions in Northern California and Nevada. If major disasters such as earthquakes or other events occur, or our information system or communications network breaks down or operates improperly, our headquarters and production facilities may be seriously damaged, or we may have to stop or delay production and shipment of our products. We may incur expenses relating to such damages, which could have a material adverse impact on our business, operating results and financial condition.

Servicing our indebtedness requires a significant amount of cash, and we may not have sufficient cash flow from our business to pay our substantial indebtedness.

We incurred \$660.0 million, \$920.0 million and \$1.38 billion, respectively, in aggregate principal amount of senior indebtedness when we issued, in registered public offerings, the 2018 Notes in 2013 and the 2019 Notes and 2021 Notes in 2014. In addition, we have established a senior secured asset based revolving credit agreement (the Credit Agreement) that allows us to borrow, under certain circumstances, up to \$1.0 billion. As of June 30, 2016, we had \$678.0 million in borrowings under the credit facility pursuant to the Credit Agreement. Our substantial indebtedness may increase our vulnerability to any generally adverse economic and industry conditions.

Our ability to make scheduled payments of the principal and interest when due or to make payments upon conversion of the notes, or to refinance the notes or our borrowings under the Credit Agreement, depends on our future performance, which is subject to economic, financial, competitive and other factors beyond our control. Our business may not continue to generate cash flow from operations in the future sufficient to satisfy our obligations under the notes or the Credit Agreement, and any future indebtedness we may incur and to make necessary capital expenditures. If we are unable to generate such cash flow, we may be required to adopt one or more alternatives, such as reducing or delaying investments or capital expenditures, selling assets, refinancing or obtaining additional equity capital on terms that may be onerous or highly dilutive. Our ability to refinance the notes or existing or future indebtedness will depend on the capital markets and our financial condition at such time. We may not be able to engage in any of these activities or engage in these activities on desirable terms, which could result in a default on the notes, the Credit Agreement or future indebtedness.

Pursuant to their terms, holders may convert their Notes at their option at any time prior to the final three-month period of the scheduled term of the respective Notes only under certain circumstances. For example, holders may generally convert their Notes at their option during a quarter (and only during such quarter) if the last reported sale price of our common stock for at least 20 trading days (whether or not consecutive) during a period of 30 consecutive trading days ending on the last trading day of the immediately preceding quarter is greater than or equal to 130% of the conversion price for such series of Notes on each applicable trading day. As a result of this conversion feature, the 2018 Notes have been convertible at their holders' option during each quarter commencing with the fourth quarter of 2013, except the first quarter of 2014. Neither this nor any other conversion feature has been met with respect to the 2019 Notes and 2021 Notes, and consequently the 2019 Notes and 2021 have not been convertible at their holders' option. Upon conversion of the notes, we will be obligated to make cash payments in respect of the principal amounts thereof, and we may also have to deliver cash and/or shares of our common stock, in respect of the conversion value in excess of such principal amounts on the notes. Any conversion of the notes prior to their maturity, or acceleration of the repayment of the notes or future indebtedness after any applicable notice or grace periods could have a material adverse effect on our business, results of operations and financial condition.

In addition, holders of the notes will have the right to require us to purchase their Notes upon the occurrence of a fundamental change at a purchase price equal to 100% of the principal amount of the notes, plus accrued and unpaid interest, if any, to, but not including, the fundamental change purchase date. However, we may not have enough available cash or be able to obtain financing at the time we are required to make purchases of notes surrendered therefor or notes being converted. In addition, our ability to purchase the notes or to pay cash upon conversions of the notes may be limited by law, by regulatory authority or by agreements governing our future indebtedness. Our failure to purchase notes at a time when the purchase is required by the indenture or to pay cash payable on future conversions of the notes as required by the indenture would constitute a default under the indenture. If the repayment of the related indebtedness were to be accelerated after any applicable notice or grace periods, we may not have sufficient funds to repay the indebtedness and purchase the notes or make cash payments upon conversions thereof.

Our debt agreements contain covenant restrictions that may limit our ability to operate our business.

The terms of our Credit Facility contain, and any of our other future debt agreements may contain, covenant restrictions that limit our ability to operate our business, including restrictions on our ability to, among other things, incur additional debt or issue guarantees, create liens, repurchase stock or make other restricted payments, and make certain voluntary prepayments of specified debt. In addition, under certain circumstances we are required to comply with a fixed charge coverage ratio.

As a result of these covenants, our ability to respond to changes in business and economic conditions and to obtain additional financing, if needed, may be restricted, and we may be prevented from engaging in transactions that might otherwise be beneficial to us. In addition, our failure to comply with our debt covenants could result in a default under our debt agreements, which could permit the holders to accelerate our obligation to repay the debt. If any of our debt is accelerated, we may not have sufficient funds available to repay it.

We may still incur substantially more debt or take other actions, which would intensify the risks discussed immediately above.

We and our subsidiaries may, subject to the limitations in the terms of our Credit Facility, incur additional debt, secure existing or future debt, recapitalize our debt or take a number of other actions that are not limited by the terms of the indenture governing our convertible senior notes that could have the effect of diminishing our ability to make payments on the notes and under the Credit Agreement when due. If we incur any additional debt, the related risks that we and our subsidiaries face could intensify.

The classification of our convertible senior notes may have a material effect on our reported financial results.

As described in the Risk Factor “*Servicing our indebtedness requires a significant amount of cash, and we may not have sufficient cash flow from our business to pay our substantial indebtedness,*” our 2018 Notes have been historically, and our 2019 Notes and 2021 Notes may become in the future, convertible at the option of their holders prior to their scheduled terms under certain circumstances. If holders elect to convert their notes, we could be required to pay them significant amounts in cash and/or deliver to them a significant number of shares of our common stock. Certain holders of our 2018 Notes have exercised their conversion rights, and other holders of our notes may do so in the future. Even if holders do not elect to convert their notes, the notes become convertible prior to their scheduled maturity dates, we would be required to reclassify such notes and the related debt issuance costs as current liabilities and certain portions of our equity outside of equity to mezzanine equity, which would have an adverse impact on our reported financial results for such quarter, and could have an adverse impact on the market price of our common stock.

Risks Related to the Ownership of our Common Stock

The trading price of our common stock is likely to continue to be volatile.

The trading price of our common stock has been highly volatile and could continue to be subject to wide fluctuations in response to various factors, some of which are beyond our control. Our common stock has experienced an intra-day trading high of \$271.57 per share and a low of \$141.05 per share over the last 52 weeks. The stock market in general, and the market for technology companies in particular, has experienced extreme price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. Broad market and industry factors may seriously affect the market price of companies’ stock, including ours, regardless of actual operating performance. In addition, in the past, following periods of volatility in the overall market and the market price of a particular company’s securities, securities class action litigation has often been instituted against these companies. For example, a shareholder litigation like this was filed against us in 2013. While the trial court dismissed the plaintiffs’ complaint with prejudice, this litigation (if the trial court’s order is successfully appealed) or others like it could result in substantial costs and a diversion of our management’s attention and resources.

Conversion of our convertible senior notes may dilute the ownership interest of existing stockholders, including holders who had previously converted their notes, or may otherwise depress the price of our common stock.

The conversion of some or all of our convertible senior notes will dilute the ownership interests of existing stockholders to the extent we deliver shares upon conversion of any of the notes. As described in the Risk Factor “*Servicing our indebtedness requires a significant amount of cash, and we may not have sufficient cash flow from our business to pay our substantial debt,*” our convertible senior notes have been historically, and may become in the future, convertible at the option of their holders prior to their scheduled terms under certain circumstances. If holders elect to convert their notes, we could be required to pay them significant amounts in cash and/or deliver to them a significant number of shares of our common stock. Certain holders of our 2018 Notes have exercised their conversion rights, and other holders of our notes may do so in the future. Any sales in the public market of the common stock issuable upon such conversion could adversely affect prevailing market prices of our common stock. In addition, the existence of the notes may encourage short selling by market participants because the conversion of the notes could be used to satisfy short positions, or anticipated conversion of the notes into shares of our common stock could depress the price of our common stock.

The convertible note hedge and warrant transactions we entered into in connection with the issuance of our convertible senior notes may affect the value of the notes and our common stock.

In connection with each issuance of our convertible senior notes, we entered into convertible note hedge transactions with the hedge counterparties. The convertible note hedge transactions cover, subject to customary anti-dilution adjustments, the number of shares of our common stock that initially underlay the applicable notes. The convertible note hedge transactions are expected to reduce the potential dilution and/or offset potential cash payments we are required to make in excess of the principal amount upon conversion of the applicable notes. We also entered into warrant transactions with the hedge counterparties relating to the same number of shares of our common stock, subject to customary anti-dilution adjustments. However, the warrant transactions could separately have a dilutive effect on our common stock to the extent that the market price per share of our common stock exceeds the applicable strike price of the warrants on the applicable expiration dates.

In addition, the hedge counterparties or their affiliates may modify their hedge positions by entering into or unwinding various derivatives with respect to our common stock and/or purchasing or selling our common stock or other securities of ours in secondary market transactions prior to the maturity of the applicable notes (and are likely to do so during any observation period related to a conversion of notes). This activity could also cause or prevent an increase or a decrease in the market price of our common stock or the notes.

We do not make any representation or prediction as to the direction or magnitude of any potential effect that the transactions described above may have on the prices of the notes or the shares of our common stock. In addition, we do not make any representation that the hedge counterparties have engaged or will engage in these transactions or that these transactions, once commenced, will not be discontinued without notice.

Mr. Musk has pledged shares of our common stock to secure certain bank borrowings. If Mr. Musk were forced to sell these shares pursuant to a margin call that he could not avoid or satisfy, such sales could cause our stock price to decline.

Certain banking institutions have made extensions of credit to Elon Musk, our Chief Executive Officer, a portion of which was used to purchase shares of common stock in certain of our public offerings and private placements at the same prices offered to third party participants in such offerings and placements. We are not a party to these loans, which are partially secured by pledges of a portion of the Tesla common stock currently owned by Mr. Musk. If the price of our common stock were to decline substantially and Mr. Musk were unable to avoid or satisfy a margin call with respect to his pledged shares, Mr. Musk may be forced by one or more of the banking institutions to sell shares of Tesla common stock in order to remain within the margin limitations imposed under the terms of his loans. Any such sales could cause the price of our common stock to decline further.

Anti-takeover provisions contained in our governing documents, applicable laws and our convertible senior notes could impair a takeover attempt.

Our certificate of incorporation and bylaws afford certain rights and powers to our board of directors that could contribute to the delay or prevention of an acquisition that it deems undesirable. We are also subject to Section 203 of the Delaware General Corporation Law and other provisions of Delaware law that limit the ability of stockholders in certain situations to effect certain business combinations. In addition, the terms of the convertible senior notes require us to repurchase the notes in the event of a fundamental change, including a takeover of our company. Any of the foregoing provisions and terms that has the effect of delaying or deterring a change in control could limit the opportunity for our stockholders to receive a premium for their shares of our common stock, and could also affect the price that some investors are willing to pay for our common stock.

Risks Related to the Proposed SolarCity Acquisition

There can be no assurance that we will successfully complete the acquisition of SolarCity on the terms or timetable currently proposed, or at all.

On July 31, 2016, we executed a definitive acquisition agreement with SolarCity Corporation (“SolarCity”) to acquire SolarCity. There can be no assurance that the acquisition of SolarCity will be completed when expected, on the terms agreed in the acquisition agreement, or at all. The SolarCity acquisition is subject to various closing conditions, including approval by a majority of the votes cast by the disinterested stockholders of each of Tesla and SolarCity, the effectiveness of the Registration Statement on Form S-4 that we will file in connection with the shares of our common stock to be issued in the acquisition, the absence of legal prohibitions on the consummation of the acquisition, customary approvals required under the Hart-Scott-Rodino Antitrust Improvements Act, and compliance with our and SolarCity’s respective representations, warranties, covenants and obligations set forth in the acquisition agreement. The conditions to closing may not be satisfied or waived or there may be other intervening events that delay or prevent the closing of the acquisition. A delay or failure in consummating the acquisition could have a negative impact on our business and the trading price of our common stock. Whether or not we acquire SolarCity, we have incurred and continue to incur substantial transaction costs, which could have a negative impact on our financial condition and results of operations.

An unfavorable outcome in any lawsuit challenging the SolarCity acquisition may delay or prevent the completion of the acquisition or result in an award of damages or a settlement for which we may be liable.

As is common following the announcement or during the pendency of a merger transaction involving a publicly held company, lawsuits arising out of or relating to the acquisition of SolarCity may be filed. Any such litigation involving us is likely to be time-consuming and expensive, with results that are difficult to predict, and could divert our management's attention away from our regular business. The existence of litigation could also adversely impact the likelihood of obtaining the approvals required of us and SolarCity in order to consummate the acquisition. If a plaintiff is successful in obtaining a judgment against us or SolarCity, such judgment may prevent the merger from being completed within the expected time frame, or at all. Moreover, a judgment for damages or a settlement resulting from litigation may be for a significant amount, and if we complete the acquisition of SolarCity, we may be liable for such amount even if such judgment or settlement is against or with SolarCity.

In specified circumstances, SolarCity may terminate the acquisition agreement to accept an alternative proposal.

The acquisition agreement permits SolarCity to terminate the agreement in order to enter into a definitive agreement with a third party with respect to a "superior proposal" (as such term is defined in the acquisition agreement) prior to obtaining approval of the acquisition from its stockholders. In such event, SolarCity's only further obligation to us would be obligated to disburse to us a termination fee. Such termination would deny us and our stockholders any expected benefits from the acquisition and could negatively impact our stock price.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULT UPON SENIOR SECURITIES

None.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

See Index to Exhibits at end of this Quarterly Report on Form 10-Q for the information required by this Item.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Tesla Motors, Inc.

Date: August 5, 2016

/s/ Jason Wheeler

Jason Wheeler
Chief Financial Officer
(Principal Financial Officer, Principal Accounting Officer and
Duly Authorized Officer)

INDEX TO EXHIBITS

Exhibit Number	Exhibit Description	Incorporated by Reference				Filed Herewith
		Form	File No.	Exhibit	Filing Date	
1.1	Underwriting Agreement, dated as of May 19, 2016, by and among Tesla Motors, Inc., Elon Musk, as selling stockholder, and Morgan Stanley & Co. LLC and Goldman, Sachs & Co., as representatives of the several underwriters named in Schedule I thereto.	8-K	001-34756	1.1	May 25, 2016	
3.1	Amended and Restated Bylaws of Tesla Motors, Inc., effective as of June 20, 2016	8-K	001-35758	3.1	June 21, 2016	
4.1	Waiver to Fifth Amended and Restated Investors' Rights Agreement, dated as of May 18, 2016, between Tesla Motors, Inc. and certain holders of the capital stock of Tesla Motors, Inc. named therein.	8-K	001-34756	4.1	May 24, 2016	
31.1	Rule 13a-14(a) / 15(d)-14(a) Certification of Principal Executive Officer	—	—	—	—	X
31.2	Rule 13a-14(a) / 15(d)-14(a) Certification of Principal Financial Officer	—	—	—	—	X
32.1*	Section 1350 Certifications	—	—	—	—	X
101.INS	XBRL Instance Document	—	—	—	—	X
101.SCH	XBRL Taxonomy Extension Schema Document	—	—	—	—	X
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	—	—	—	—	X
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document	—	—	—	—	X
101.LAB	XBRL Taxonomy Extension Label Linkbase Document	—	—	—	—	X
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	—	—	—	—	X

* Furnished herewith

RULE 13a-14(a)/15d-14(a) CERTIFICATION

I, Elon Musk, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Tesla Motors, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 5, 2016

/s/ Elon Musk

Elon Musk
Chief Executive Officer
(Principal Executive Officer)

RULE 13a-14(a)/15d-14(a) CERTIFICATION

I, Jason Wheeler, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Tesla Motors, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's Board of Directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 5, 2016

/s/ Jason Wheeler
Jason Wheeler
Chief Financial Officer
(Principal Financial Officer)

SECTION 1350 CERTIFICATIONS

I, Elon Musk, certify, pursuant to 18 U.S.C. Section 1350, that, to my knowledge, the Quarterly Report of Tesla Motors, Inc. on Form 10-Q for the quarterly period ended June 30, 2016, (i) fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and (ii) that the information contained in such Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of Tesla Motors, Inc.

Date: August 5, 2016

/s/ Elon Musk
Elon Musk
Chief Executive Officer
(Principal Executive Officer)

I, Jason Wheeler, certify, pursuant to 18 U.S.C. Section 1350, that, to my knowledge, the Quarterly Report of Tesla Motors, Inc. on Form 10-Q for the quarterly period ended June 30, 2016, (i) fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and (ii) that the information contained in such Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of Tesla Motors, Inc.

Date: August 5, 2016

/s/ Jason Wheeler
Jason Wheeler
Chief Financial Officer
(Principal Financial Officer)

