

Automotive News

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9 QUESTIONS

Tesla, still struggling financially, is making a bold play to upend its go-to-market strategy by closing stores and moving to online-only sales. While the influence that strategy will have on the industry is contingent on the electric-vehicle maker surviving and thriving, the result could be far-reaching.

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1. Will Tesla run into legal roadblocks?

It's possible. Some state dealer association leaders say Tesla operates illegally in their states, but if the automaker were to close its sales and service locations and go to online-only sales as it plans, that also could violate some states' statutes that require a physical location.

"The attorney general in each state is going to have to look at how the online-only selling of vehicles complies with the laws in those states," said Robert O'Koniewski, executive vice president of the Massachusetts State Automobile Dealers Association.

Tesla CEO Elon Musk was asked in a conference call Feb. 28 if he was concerned that the online-only model would meet further resistance, especially from auto dealers touting state franchise laws.

"I'm sure the franchise dealers will try to ... oppose us in some way but this would be a

fundamental restraint of interstate commerce and violate [the] Constitution," Musk said. "So good luck with that."

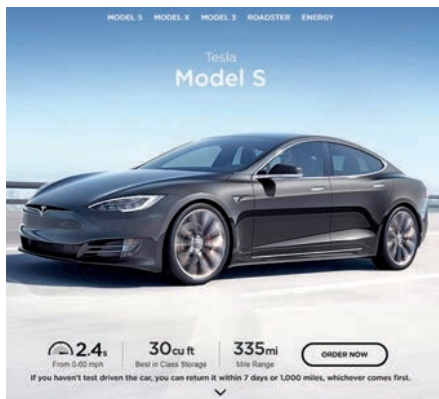
Musk was referring to the Commerce Clause of the U.S. Constitution, which says Congress has power over interstate trade, but the clause has been subject to differing

interpretations in arguments of state vs. federal power.

Len Bellavia, a New York lawyer specializing in dealer franchise law, said Musk's comments are overly simplistic. The clause is "not a free pass because states do have a right to regulate a legitimate interest in health, safety and welfare," Bellavia said. "To the extent he's relying on the interstate Commerce Clause, I think he's in for a surprise or at least a battle on several fronts."

In addition to franchise statutes, those fronts could include state laws and regulations governing licensing, so-called lemon vehicles and wet-ink signature requirements, Bellavia and some dealer association leaders said.

In California, for instance, Tesla's online-only retail strategy would violate state law requiring wet signatures for vehicle sales and leases, said Brian Maas, president of the California New Car Dealers Association. To sell vehicles in California, Tesla must also have a



Tesla's plan to shift to online-only sales could run into problems in a number of states.

brick-and-mortar site where the Department of Motor Vehicles can serve papers and where vehicle sales are conducted, Maas said.

Though some of Tesla's California stores closed last week, it still lists many retail locations in the state.

And it remains to be seen what an online sale means to Tesla. Though many traditional dealers and used-vehicle sellers such as Carvana handle much of a vehicle sale online, the fully online transaction remains elusive, blocked by legal hurdles such as those signature requirements.

Morningstar analyst David Whiston noted that the laws are not written for today's technology. He added, "So it's not quite as simple in some states as buying the car on your phone in one minute as Tesla said."

2. What do other automakers think?

If Tesla succeeds with online-only sales, will other startup automakers follow? And will the legacy automakers flex their muscles in pursuit of the same? Both are possible.

"From our discussions with [automakers] over many years, most auto companies would love to sell vehicles the way Tesla does," Morgan Stanley analyst Adam Jonas wrote last week in a note to investors. "There's just one catch. They can't. It's against the law."

State franchise laws generally limit automakers with franchised dealers from selling direct and competing against those retailers.

The Alliance of Automobile Manufacturers declined to comment about Tesla's announcement. In the past, the alliance has opposed some Tesla-related legislation, arguing

the measures would give Tesla an unfair advantage over its members such as General Motors, Volkswagen and Toyota.

GM in the past has objected to Tesla plans to add stores. In 2014, GM sent a letter to then-Ohio Gov. John Kasich asking Ohio to oppose legislation that would provide an exemption for Tesla in how vehicles were sold and that would "essentially allow Tesla to compete under a completely different set of rules." GM last week declined to comment on Tesla's new strategy. But in a statement, GM spokesman Jim Cain said its dealers are hugely important to its business and are "a strategic advantage."

Chris Sutton, vice president of the U.S. automotive retail practice at J.D. Power, said he doesn't expect traditional automakers to follow Tesla "because of the established relationships. It would be very difficult to walk that back."

But automotive startups, free of a franchised dealer network, could consider an online-only sales model.

"I could see them taking the same route with factory-owned stores, or an online-only model," Whiston said. "They see Tesla not franchising, so they will think they can do it, too."

But introducing a brand without a brick-and-mortar retail presence would be a challenge, Sutton said. "It would be incredibly expensive to market and fund that."

Detroit electric vehicle startup Rivian plans to offer its vehicles through a direct-sales model, according to a company spokesman. He declined to give specifics.

Two Chinese brands that plan to start selling in the U.S. — GAC and Zotye — have said they will use franchised dealers and have started recruiting retailers.

Zotye last week reiterated its commitment to franchised dealers. But "the internet will be a critical part of our sales and marketing operation supporting our dealers," Bob Pradzinski, Zotye USA senior vice president of sales, said in a statement.

3. Are Americans prepared to buy luxury vehicles sight unseen?

It may be fine with Tesla's loyal fan base and early adopters. But it becomes more of a challenge as Tesla scales up to volume production. And a generous return policy might not be enough for some buyers.

Tesla's tall order

Tesla says its shift to online-only sales encompasses several other changes including:

- Enabling customers to buy vehicles on a mobile device in less than 1 minute
- Cutting vehicle prices 6% on average
- Offering a 7-day/1,000-mile vehicle return policy
- Providing same-day, or even same-hour service, mostly by mobile repair units going to customers' locations
- Improving vehicle software to increase the range, speed and power on select models

Source: Company report

Tesla needs to appeal to the mass market, Whiston said. It may be tough to ask those customers to take on a large upfront obligation without a free test drive first.

"The online method works great when one is 100 percent sure they want a Model S, a 7 series, a 911, Corvette or whatever," Whiston said. "But if a consumer is really undecided between, say, a Tesla, an Audi and a Mercedes, and they are not obsessed with Elon, that person may just prefer to go to the dealer and test drive something before signing a contract."

Carvana CEO Ernie Garcia is familiar with people buying used vehicles online without first laying eyes on them. He told CNBC last week that he "wouldn't be betting against" Tesla's latest move.

Garcia, whose company's sales have had triple-digit growth as it expands its online used-vehicle model across the U.S., acknowledged that buying a new vehicle online may pose different questions to consumers. "But I think that return policy is enormously powerful, just like it is on the used side," he said.

Tesla's online sales focus could be a boon for Carvana by fueling awareness of the practice. "Tesla has an incredible megaphone," Garcia said. "Even though competition isn't that important in this industry because of the size, they're not directly competitive. So they're going to be telling the story, and we're really excited about it, to be honest."

4. Why the sudden strategy shift?

Tesla's pivot to online-only sales caught many analysts, Tesla employees, customers and industry insiders off guard and seems counter to moves it had been making. The company, in a regulatory filing last month, said it was expanding its U.S. retail footprint and touted the flexibility it gives customers by letting them order online or at Tesla stores. It also continued to pursue changing state fran-



Bellavia: "Not a free pass"



Garcia: Wouldn't bet against Tesla

chise laws, with several bills being introduced in state legislatures over the past two months.

In December, Tesla said it was opening 11 stores and galleries; just three months later, seven of those operations have been shuttered. Information on Tesla's website indicates the company last week closed 24 stores and galleries across the U.S., leaving 105 open as of Friday, March 8.

Tesla's move could be largely financially motivated. Musk, in a Feb. 28 conference call, said the store closures and head count reduction would help the company achieve savings needed to offer a long-promised \$35,000 Model 3 and to be financially sustainable.

He also acknowledged that Tesla is now expected to lose money in the first quarter of 2019. In a blog post the same day, Tesla said it would close many stores over the next few months, though a "small number" in "high traffic" areas would remain open as galleries or information centers.

Matthew Rash, delivery supervisor at a Tesla sales and service site in Indianapolis, said he is not surprised by the change. "It makes sense since most of our orders come from strictly online," he said. Rash estimated 80 percent of his location's sales are online with the rest from people who visit the store.

He said he expects his location to stay open because it includes service.

5. Will Tesla consider using franchised dealers?

That ship has probably sailed. For years, Musk said he would consider turning to franchised dealers as volume grew. In 2013, he told *Automotive News* that could happen after Tesla sales had captured a 1 percent share of the U.S. new light-vehicle market.

That day is here. In 2018, buoyed by the Model 3 introduction, Tesla's estimated U.S. sales were 182,400 vehicles, a 1.1 percent share, according to the Automotive News Data Center. That share had grown from an estimated 0.3 percent in 2017.

Whiston said he once thought Tesla would turn to franchising after the Model 3. But "now I suspect they have no intention of franchising ever," he said. "I think Musk wants too much oversight of everything to franchise."

Musk noted that the lack of a franchised dealer network makes Tesla's online-only retail model possible.

"This will be a fundamental long-term competitive advantage of Tesla that maybe ... only a startup could replicate," Musk said on the Feb. 28 conference call.

Still, others think Tesla eventually could turn to franchising, particularly if this effort stumbles.

Craig Bickmore, executive director of the New Car Dealers of Utah, which worked with Tesla a year ago on a legislative solution allowing Tesla to sell vehicles in the state, said franchising Tesla stores to dealers would help the company in merchandising, service and used-vehicle sales.

6. What do online-only Tesla sales mean for existing lawsuits and active legislative efforts?

The lengthy, costly and high-profile legal battles involving Tesla, dealer associations and certain states could continue to play out in courtrooms.

"Only Tesla knows what Tesla will do," Robert Bird, a business law professor at the University of Connecticut, told *Automotive News*.

Tesla's action to continue cases could signal that its online-only sales shift may not be permanent, Bird said.

Tesla sued Michigan in 2016 in federal court over the state's ban on direct sales. That case is to go to trial in June. A lawyer for Tesla in the Michigan case referred *Automotive News* to Tesla for comment. Tesla didn't respond to a request for comment by press time.

Another lawsuit in which the Virginia Automobile Dealers Association in 2016 sued Tesla and the state's Department of Motor Vehi-

cles Commissioner Richard Holcomb is scheduled for trial in October.

If Tesla dropped the Michigan lawsuit and failed to mount a vigorous defense in the Virginia case, "that signals to the consumers and investors that this is more likely to be a long-term retreat" from having stores, Bird said.

Several states — including New Jersey, Connecticut, New Mexico, Nebraska, Oklahoma, South Carolina and West Virginia — also have introduced legislation this year that would positively impact Tesla and its ability to sell vehicles in each state.

Legislation was thought to be close to introduction in Texas. But Tesla postponed an event last week in Austin and told the *Austin American-Statesman* March 1 it was "recasting our policy priorities" after its sales approach announcement.

What happens in each state may depend on whether Tesla was pushing for changes, which could slow momentum, or whether legislators were motivated to initiate changes because of free-market or customer service arguments, Bird said.

In New Mexico, where Tesla is banned from operating stores, a Senate bill would allow the sale of electric vehicles directly to the public. State Sen. Jerry Ortiz y Pino, a sponsor of that bill, wrote in an email to *Automotive News* that Tesla's online-only sales announcement could signal that Tesla will want to revise the bill in his state to allow the company to open a service center for online customers.

"Actually, there may not be a need for legislation after all as the prohibition against Tesla operating here is based on the ban against automobile manufacturers selling their product to the public directly within the state," Ortiz y Pino said. "That won't apply if the sales are online." New Mexico's legislative session ends March 16.

7. How will online-only Tesla sales affect consumers?

Does a physical location help a consumer when something goes wrong with a vehicle? Dealer advocates say yes. Consumers need a place to seek recourse. And most buyers still want to kick the tires.

Don Hall, CEO of the Virginia Automobile Dealers Association, said he believes Tesla is not following numerous consumer protection laws in Virginia.

"They say they're going to have some service facilities located in various locations. What does that mean and who and where and what?" Hall said. "Though the franchise system is literally over 100 years old now, it has worked for a reason, not because we're dinosaurs holding onto dinosaur practices. But more because a car is a huge purchase in one's life."

On the buying side, as long as Tesla's e-commerce model is transparent, it could work in shoppers' favor, consumer advocates say.

They should have the chance to consider vehicle purchase documents more carefully without the pressure that comes from spending hours at a dealership, said Rosemary Shahan, president of Consumers for Auto Reliability and Safety, a nonprofit auto safety and consumer advocacy organization. "It puts the consumer more in the driver's seat."

At a traditional dealership today, said Jack Gillis, executive director of the Consumer Federation of America, paperwork "is so convoluted and complex that it's easy for consumers to inadvertently sign onto things they may not really need or want."

On the service side, Gillis added, it is critical that Tesla has some type of repair infrastructure. "If they can't also service the needs of consumers, the system will fail."

8. What does Tesla's switch to online-only sales mean for the company's service strategy?

Moving to online-only sales means service is more important than ever if Tesla wants to keep people engaged with the brand, Simon Bradley, global practice director at Urban Science, told *Automotive News*.

Service, if handled properly, likely will cost more for the automaker, observers said.

Tesla said it will increase investment in service by an undisclosed amount, adding technicians, "with the goal of same-day, if not same-hour, service." Most service will be done by mobile repair units going to customers, the company said.

Musk in a Dec. 11 tweet said, "We're opening a lot of Tesla service centers next year, including Knoxville. Tesla will post upcoming city opening map this week." *Automotive News* could not find a map of the expansion on Tesla's website or in its tweets.

As the number of Tesla vehicles on the road swells, congestion and wait times have increased at the automaker's factory-owned service centers.

To ease that pressure and address the surge in Model 3 volume, Tesla last year significantly expanded its mobile service program, which rolled out in 2009 and involves technicians performing vehicle repairs in driveways and office parking lots.

Tesla has said more than 80 percent of repairs can be done without a visit to a service center. That said, Tesla is keeping physical service locations and has morphed some sales-and-service centers to service only.

One state dealer association chief said Tesla's expansion of mobile techs poses risks.

O'Koniewski said it is illegal where he lives to conduct work on a vehicle for commercial purposes on the street. And does Tesla carry adequate workers' compensation and other insurances to cover accidents that happen at a customer's home? "If something happens to that repairman, how is that covered?" O'Koniewski asked.

Some critics say that reliably offering same-day service, let alone same-hour service, seems ludicrous, especially given geographic constraints. Tesla can diagnose and make some repairs using cloud-based software. But how will it handle a surge of demand in the event of a recall that requires a mechanical repair — a suspension arm prone to fracture, for instance?

Logistics and liability costs have kept traditional dealers from experimenting much with mobile repair, dealer sources said.

For Musk, that makes service another area in which he can set Tesla apart from traditional automakers and their retailers — though it remains to be seen whether it's in a positive or negative way. Tesla's service operation reports directly to Musk, the CEO said after Tesla's Feb. 28 announcement.

Musk said on a conference call, "My top priority this year is making service amazing at Tesla."

9. Could this be a step toward bankruptcy for Tesla?

What the pivot means for online sales industrywide is contingent on Tesla surviving.

Musk told news service Axios in November that the company was "within single-digit weeks" of failure during the Model 3 buildup. Tesla has slowed its cash burn since then, but it's not out of the woods.

Tesla made a \$920 million bond payment due March 1, the day after it announced the change in its go-to-market strategy. But cash flow problems could continue this year, analysts say.

Jonas forecast last week that Tesla will burn



Hall: Franchise system works.



Musk: Brush with failure

Closing time

Tesla has closed at least 24 stores and galleries since Monday, March 4. The closed operations and their cities:

California

- Monterey-Seaside
- Palm Desert-The Gardens on El Paseo
- Rancho Cucamonga-Victoria Gardens
- Roseville-Galleria at Roseville Showroom
- Sherman Oaks-Fashion Square Mall
- The Tesla Gallery at Nordstrom The Grove in Los Angeles

Connecticut

- Greenwich-Greenwich Avenue

District of Columbia

- CityCenterDC

Florida

- Jacksonville-St. Johns Town Center
- Miami-Design District
- Tampa-Florida Ave.
- West Palm Beach

Georgia

- Atlanta-Decatur

Hawaii

- International Market Place in Honolulu

Illinois

- Chicago-West Grand Avenue
- Oak Brook-Oakbrook Center

New Jersey

- Garden State Plaza in Paramus

New York

- Brooklyn-Van Brunt Street
- East Hampton-Newtown Lane

North Carolina

- Charlotte-SouthPark Mall

Pennsylvania

- Ross Park Mall in Pittsburgh

Texas

- Dallas Galleria
- Fort Worth-Shops at Clearfork
- San Antonio-La Cantera Mall

Source: Company website

through \$621 million in the first quarter. And without raising capital, Tesla's cash could get as low as \$1.5 billion this year, Jonas wrote in a note to investors. That compares with Tesla's \$3.7 billion in gross cash at the end of 2018.

"The last time Tesla's gross cash was in the \$1.5 billion range was [the first quarter of 2016] when Tesla was barely one-fifth the size it is today by revenue," Jonas wrote in the note.

Jefferies analyst Philippe Houchois said, "It all depends on the profitability of what they produce between now and the end of the year."

Houchois predicts Tesla could run into cash flow problems in the first half as it ships vehicles to Europe and China, given the risk of delays in working capital related to the shipments.

And can the company generate cash on the \$35,000 and \$40,000 versions of the Model 3 it will soon be producing? That's what matters, Houchois said.

Questions remain about Tesla's long-term viability, Fitch Solutions said. And there are risks to delivering cars en masse, Fitch auto analyst Aleksei Vjazinkin told *Automotive News*.

"In the past, the customer service department has struggled to work effectively," Vjazinkin said. "That's why it's now under Elon Musk's wing."

But it's hard to imagine Tesla going away, others say.

"The company's brand power is incredible and just getting started," Gartner analyst Mike Ramsey said. "There is a chance that some more restructuring is ahead, but the company is sticking around." **AN**