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Tesla's Online-Only Model Leaves Many Experts Baffled



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The Tesla logo hangs outside the door to a company store in Cherry Creek Mall in Denver. (AP Photo/David Zalubowski)

Last week, Tesla (NASDAQ: TSLA) announced its unexpected decision to abandon physical retailing locations and move to online-only sales. Tesla's CEO, Elon Musk, stated that online sales would lower the company's operating expenses and allow the automaker to reduce its vehicle prices, thus increasing sales volume and helping it edge closer to consistent profitability. But Tesla's

decision shocked the industry as it was counter to many of its previous retailing and growth plans, and from most vantage points, it doesn't make much sense (legally, practically, or fiscally) to many industry experts.

The legal argument...

On the day of the announcement, Musk held a private invitation-only conference call with journalists, who asked if the move would face opposition from state regulators that enforce franchise laws. Musk explained that online-only sales would allow Tesla to circumvent them, saying, "I'm sure the franchise dealers will try to oppose us in some way, but to do so would be a fundamental restraint on interstate commerce and violate the Constitution. So, good luck with that."

The concept of using online sales to bypass franchise laws isn't new to Tesla. For example, In Texas, where direct to consumer new vehicle sales are prohibited, customers must buy a vehicle online, then Tesla ships their car from states where it's licensed to sell. But if Tesla closes its retail locations in states where it legally operates, it's not clear if it will lose its licensing. Leonard Bellavia, a lawyer and franchise law expert disagrees with Musk's legal opinion, "The statement by Musk that state dealer franchise laws prohibiting factory direct sales are unconstitutional is an overly simplistic and rather bald-faced generalization." And while Tesla plans to close its retail sales locations, it intends to expand its service network, which is also fraught with legal issues, according to Bellavia, "An online sale only model would require both a sales and service facility to satisfy state licensing authorities, which defeats the purpose of online sales." Musk didn't address the service-related legal issues in his announcement.

But Tesla's legal issues aren't limited to just franchise laws; there are also other state and local regulations that create a regulatory moat around online vehicle sales. In certain states and municipalities, a "wet signature" or in-person signature is required for some or all vehicle delivery paperwork. It's also unclear how online-only sales will affect each state's new car lemon laws, which were written based on sales occurring within the respective state.

Most car buyers aren't ready to buy online...

Counter to the hype surrounding the predicted exodus of car buyers from dealership showrooms, the mainstream new car buyer is not ready for online-only vehicle sales. Last year, my consulting firm researched e-commerce consumer trends in the automotive industry, and we learned that while many new car buyers would prefer to buy online, a majority of transactions are still not well-suited for online sales. The reasons vary by customer segment, but the explanations generally revolve around the ability to view and test drive a vehicle; review features and options in-person; the complexity of financing options and credit approval; the need for an in-stock vehicle; and finally, appraising a trade-in vehicle. In fact, more than 40% of new vehicles financed in the U.S. involved a trade; and while major advancements have been made in appraising trades remotely, in almost all scenarios, an in-person inspection is required to pay the highest amount to a vehicle owner.

But Tesla doesn't seem concerned about the limitations of online-only sales for the traditional new car buyer. For example, to overcome the hurdle of test drives, Musk explains "You can now return a car within 7 days or 1,000 miles for a full refund. Quite literally, you could buy a Tesla, drive several hundred miles for a weekend road trip with friends and then return it for free." But as someone who oversaw an extended test drive program with the BMW 7 series only a few years back, I can attest that these programs often cost more than they achieve, while also attracting chronic abuse from non-buyers. While Tesla will likely initiate safeguards to prevent abuse, such as requiring full payment upfront, it remains unclear how Model 3 customers can "test drive" vehicles without undergoing

major inconveniences if they wish to return them. Being responsible for sales tax (which is likely not refundable by state law) as well as the vehicle depreciation (as the vehicle is considered used once registered) are just two issues. It's also uncertain how these customers will be able to purchase a different vehicle as their credit will be weakened before/during the refund process and likely weeks after.

Some experts claim that Tesla is biased by its experience with Model S and X customers, which have an average income that is nearly 50% higher than the typical luxury car owner. These high-earners have more flexibility than the Model 3 buyers, including (in most cases) having another vehicle at home, and are, therefore, better able to adapt to the uncertainties and inconveniences of online-only sales. But the Model 3 mass market customer needs a vehicle to go to work and perform other everyday functions and is more restricted by vehicle downtime, while also being more financially constrained.

Not a zero-sum game...

The elimination of physical store expenses will create new costs, many of which Tesla might not have prepared for. Musk explains, "We will be closing some stores, and there will be a reduction in headcount...Unfortunately, there's no way around it. We're sort of in a binary choice. Reduce headcount and sell the \$35,000 car and have fewer people, or not provide a \$35,000 car." But what about new costs that will be incurred from the online-only model? There are obvious expenses, like call centers, shipping and logistics costs, and IT infrastructure. But there are also less obvious costs, like those related to providing support for vehicles damaged or having mechanical misfunctions at delivery, as well as educating new owners on their vehicles. Finally, will enhanced advertising efforts be needed to counter a lack of physical presence? Experts explain this isn't a "zero-sum game," and the tangible and intangible costs might be underestimated by the automaker.

"Betting the house" on online-only sales is seen as a risk for the automaker...

Many industry experts feel that the online-only model is not yet viable for a mass-produced vehicle, and they also question if it will improve Tesla's profitability.

But it is certain that this new approach will create obstacles that could dampen Tesla's efforts to sell the Model 3 at a time when the fledgling automaker needs to achieve scale. While it's left to speculation, many experts predict that Tesla's online move will be clarified over the coming weeks as Tesla consumers and investors become increasingly concerned.
