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As Tesla Faces Latest Cash Crisis, Musk Might Want To Consider Franchise A Dealership Model

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Elon Musk, co-founder and chief executive officer of Tesla Inc., speaks during an unveiling event for the Boring Co. Hawthorne test tunnel in Hawthorne, Calif., on Tuesday, Dec. 18, 2018. Musk has unveiled his underground transportation tunnel, allowing reporters and VIPs to take some of the first rides in the subterranean tube, which the tech entrepreneur says is the answer to what he calls "soul-destroying traffic." (Robyn Beck/Pool Photo via AP) ASSOCIATED PRESS

Last week, Elon Musk, Tesla's CEO, notified employees that the company needed to improve its profitability to become a "viable company." This meant a 7% reduction in hourly and salaried staff, the elimination of its sales referral program, and an increase in its Supercharging pricing. But despite changes, Tesla has a record of costly and capital-intensive decisions, in part because the company prides itself on doing things differently. For example, Tesla opted to build commoditized components, such as seats, in-house, rather than relying on global seat suppliers that can produce more efficiently. Tesla also assumed that automation would reduce labor costs and speed up production, but as the legacy auto industry already knew, robots cannot yet replace human hands for every function. And while this last item might surprise some, one major area where Tesla has received very little return on its investment is its direct sale model.

It's no secret that Tesla does not want franchise dealers. The company's stance is based upon the notion that franchised dealers cannot properly sell electric vehicles (EVs). So, Tesla spent billions of dollars on its own retail locations, service centers, call centers, and the personnel to populate them. As a result, despite its high gross margin, **Tesla has the highest selling, general, and administrative (SG&A) expenses of any of its established competitors (on a per unit basis),** expenses that have not meaningfully reversed even as Tesla's sales volume increases.

Tesla operates a U.S. network of 125+ retail locations, 75+ service centers, as well as multiple call centers. **To build this network, Tesla procured the land or space for these properties, then designed, constructed, and equipped these locations. It then hired, trained, and staffed local salespeople to sell and deliver vehicles and hired skilled technicians and service-related staff**. But with a franchise model, all of these tasks (and the associated financial debt and liability) would be left to Tesla's dealers, who would have to build and staff Tesla retail stores, call centers, and service centers in accordance with its brand standards. This reality holds true with any automaker today that requires its franchise dealers to provide facilities and staff in accordance with its unique standards, including prohibiting the sale of other makes.

New vehicle inventory management is another area where automotive incumbents have a lead over Tesla. **Traditional automakers are instantly paid by dealers as soon as a vehicle leaves the factory floor**. Thus, automakers are not liable for the cash (or balance sheet debt) for vehicle inventory, including vehicles that are used for test drives at the dealership. Tesla could eliminate the expenses and balance sheet debt associated with new cars, even with its build-to-order model (which was intended to reduce inventory). **As Tesla continues to increase sales, especially with its goal of 500,000 units or more, new car inventory carrying costs will prove even more burdensome**.

Revamping used vehicle inventory management also poses a significant benefit to Tesla. The automaker is currently responsible for the residual risk of vehicles at lease maturity as well as reselling them after lease-end. These tasks include inspecting and readying these units for retail sale, while also paying the interest expense to inventory them. So, for example, if a lease for a Tesla Model S is based on the vehicle being worth $60,000 at lease-end, and it's only worth $50,000 when retailed, then Tesla is responsible for the $10,000 difference plus all the costs it incurred to sell the vehicle. These are responsibilities generally reserved for franchise dealers, so it's no surprise that Tesla is struggling with used vehicle remarketing to the point that it cannot fulfill the bare necessities, such as fixing cosmetic repairs or even providing photos of its inventory.

According to U.S. Tesla inventory consolidator, EV-CPO.com, Tesla currently has over 1,500 used vehicles for sale in the U.S., some of which are more than two years old and have had price reductions in excess of $50,000. If Tesla had dealers, they, not the automaker, would carry the expense burden and price risk associated with selling used vehicles by the creation of a certified pre-owned program that is similar to those currently offered by several automakers. For example, most new vehicles that are leased from BMW Financial Services (BMW's captive lender) will be immediately sold to a BMW dealer at lease maturity. BMW dealers are required to purchase a high percentage of off-lease units at either the lease contract's residual price or the current wholesale market price even if they do not wish to retail them. By increasing the number of independent sellers in the market that are obliged to buy off-lease inventory, BMW has greater control over residual values, which lowers its depreciation costs and associated liability. To handle the flow of incoming vehicles, BMW dealers have been forced to develop efficient remarketing processes that generally sell these units within 30-to-45 days after lease-end, while lowering the overall per unit selling expenses and also turning inventory more quickly. Incidentally, via customer satisfaction scores, BMW penalizes dealers that do not perform cosmetic repairs or provide accurate photos of their vehicles.

Many skeptics have argued against an indirect franchise model, stating that Tesla would need to increase prices in order to support it. But the average gross profit per new vehicle retailed by franchise dealers in the U.S. is only $2,231, a slim margin for Tesla to consider given that most of its model variants sell for over $70,000. Moreover, Tesla's low maintenance requirement but highly technical vehicles are an ideal profit center for a dealership. Tesla service shops, operated by franchise dealers, could benefit from a high throughput for vehicles needing maintenance, and for technical repairs, they are less likely to lose repairs to independent shops as Tesla vehicles are highly specialized. And since dealers make a profit on service, they would be incentivized to build the capacity to meet their local customers' needs. This is especially relevant to the automaker's growth strategy as many **Tesla owners have complained in online forums that current customer pay maintenance and repair costs are excessive, never mind long wait times**.

While Tesla currently has a high gross margin, it gives it away with the highest SG&A among the major automakers. **As the automaker grapples with its latest cash issues, it might consider that several Chinese automakers (many of which are producing EVs at lower price points than Tesla) have concluded that the franchise dealer model is the most effective method to sell their vehicles in the U.S. market**. As Tesla continues to scale its model and is forced to act and compete more like a traditional automaker, it will need to consider options that allow it to invest in building better vehicles at lower prices, rather than investing in low margin and capital-intensive ancillary services. **This reality is becoming increasingly pressing to the automaker as it now faces intense EV competition from both the Chinese and incumbent automakers while also losing the benefit of tax credits**.