

# Can Tesla scale up without watering down its brand?

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## Tesla Speeds Ahead in the Electric Vehicle Market

“The Week that Electric Vehicles Went Mainstream,” is how **Tesla** Motors headlined its blog post last week, citing more than 325,000 pre-bookings for the Model 3 electric car it launched on March 31. “[That] corresponds to about \$14 billion in implied future sales, making this the single biggest one-week launch of any product ever,” the company boasted. Deliveries are set to begin in 2017.

**Tesla** may well be on the way to mainstreaming the electric vehicle market for itself and its competitors. In addition to the wide appeal the Model 3 seems to command, several other aspects point to a potential journey away from a niche market for **Tesla**. The car’s \$35,000 price tag is half the price of the Model S (\$75,000) and the Model X (\$80,000). Bookings for the Model 3 have surprised even **Tesla**’s founder and CEO Elon Musk, coming at a time when gasoline prices are low.

“Electric vehicles increasingly are being seen not necessarily as green or as a way to save on fuel costs, but as incredibly powerful, with amazing acceleration, and fun to drive,” said Wharton management professor John **Paul MacDuffie**, an automobile industry expert. In fact, he noted that the organizers of the Formula One auto races (Fédération Internationale de l’Automobile, or FIA) have launched a separate series for electric vehicles called the Formula E. Even the Formula One cars are all hybrids, combining the high acceleration of electric vehicles with traditional engines, he noted.

**Wesley R. Hartmann**, **marketing** professor of management at Stanford University, said the Model 3 “is the make or break for whether the electric vehicle market will take off and whether **Tesla** will be a critical part of it, as opposed to being a niche player.”

MacDuffie and Hartmann discussed **Tesla**’s Model 3 and the challenges the firm faces in tapping the mainstream market on the Knowledge@Wharton show on Wharton Business Radio on SiriusXM channel 111.

## Kudos Flow In

MacDuffie said it was “telling” that **Carlos Ghosn**, chairman and CEO of Nissan of Japan and Renault of France, has welcomed the Model 3 bookings, “because it suggests a growing and enthusiastic market for these vehicles.”

MacDuffie also noted that bookings have been strong despite low gas prices, indicating that gas prices are not the primary driver of demand for electric vehicles. “People buying a \$70,000 to \$110,000 car aren’t worried about what they pay out at the gas pump,” he said. “If the demand exists even with gas prices being low, it is [because] of that repositioning away from just an environmental pitch.”

Hartmann said the enthusiasm for the Model 3 “speaks to what **Tesla** has been able to communicate to the market in terms of the products they can develop and how much people would want those.” He likened it to “people lining up to get” the latest Apple iPhones.

“Electric vehicles increasingly are being seen not necessarily as green or as a way to save on fuel costs, but as incredibly powerful [and] fun to drive.”—John **Paul MacDuffie**

MacDuffie put the pre-bookings for the Model 3 in perspective. The \$1,000 down payment that **Tesla** requires is not an order commitment and is a refundable deposit, he noted. “But it is an extraordinary interest-free loan to **Tesla** to get in the queue and to have the bragging rights of being early to get a hot product,” he said.

Indeed, the excitement over the pre-bookings for the Model 3 were tempered this week, when **Tesla** announced a recall of 2,700 Model X SUVs after it found that the third-row seat backs could collapse forward in some accidents.

## Braving New Competition

If other automakers are keenly watching the progress of the Model 3, they would want to jump in, too. “What if competitor products are available earlier and they are good [and] well-priced?” asked MacDuffie. That could affect **Tesla**’s bottom line, he noted, but “if it’s a growing market, there should be room for everybody.”

Wharton **marketing** professor Americus Reed is optimistic for **Tesla**. “**Tesla** will be fine because it is a strong **brand** that is positioned as and is seen as very different from the other car manufacturers’ attempts at creating an electric car,” he said.

Reed added that Musk’s own **brand** image has also helped build a moat around **Tesla**. “Part of [**Tesla**’s] **brand** is a clear futurist visionary who himself is changing the world,” Reed noted, referring to Musk’s other roles as the founder of space transportation company SpaceX and co-founder of solar power company SolarCity.

“[Musk] is this larger-than-life character who makes you think of — in the computer industry — Steve Jobs, but [also] in the early auto industry history someone like Henry Ford,” said MacDuffie. “[Their] charisma and the boldness of their vision had an influence on people.”

Even so, questions persist about whether **Tesla** can pull it off, MacDuffie added. “The big question is: Can they really scale it up? What will the model look like when [the Model 3] hits the market at that price point? Will the price stay put or edge up?”

MacDuffie noted that **Tesla** has been a niche, low-volume producer, and the Model 3 would put it much more into the mass-market, mass-production range. “They haven’t done that before,” he said. “But they have learned to do other stuff that they didn’t know how to do, and so it would be risky to bet against them.”

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## Reverse Route

The Model 3 would also benefit from the luxury **brand** image of **Tesla**’s earlier models. MacDuffie noted that most automakers have historically started with inexpensive vehicles as they established their reputations, manufacturing capabilities, supply chains and dealer networks. They moved up-market at a later stage, sometimes by introducing new **brands** — as with the Lexus from Toyota, he explained. “**Tesla** did it exactly the opposite way; it established itself at the luxury end,” he said. “Obviously, it will benefit from the way in which that luxury **brand** cachet will rub off on the Model 3.”

MacDuffie noted that Musk has attributed to “hubris” his decision to move from the original Model S to a more expensive car with the Model X (\$80,000 and upwards). “That suggests a willingness to learn from a mistake,” he said. “In a way, **designing** a lower cost car is a big **design** and engineering challenge.”

Rather than **Tesla**’s luxury **brand** cachet rubbing off on the Model 3, “the more interesting question is the reverse,” said Reed. “What will happen to the **brand** as a unique luxury high end vehicle if suddenly it is ubiquitous in the mass market? What will a high-wealth individual who paid \$70,000 or more think when he sees these \$35,000 versions?”

## Value Proposition

Hartmann said that with the Model 3, **Tesla** may have hit upon a winning idea. It would have an electric vehicle for customers who cannot afford \$70,000 but also don’t want to buy some other low-end vehicles in the market. “Most people expect that they’re probably not going to get half the car [with the cheaper model, but] a lot more than that — something somewhere in between,” he said. “That seems to offer an awful lot of value.”

The value proposition could get better for customers with the federal tax credit of \$7,500 on each vehicle, but that has its limits. The tax credit scales back once a company has sold 200,000 electrical vehicles, said MacDuffie. **Tesla** has thus far sold 110,000 vehicles, which

means the next 90,000 **tesla** buyers would get the full tax credit, he explained. The tax credit is subsequently scaled back, and it will disappear at some point, he added. “It is meant to prevent the big companies that have introduced electric vehicles from scooping up all the rebate monies; it is [meant to] encourage startups like **Tesla**.”

Hartmann expected **Tesla** to live up to the expectations built around the Model 3. He said customers of **Tesla**’s Model S “are incredibly happy with them.” **Tesla** had admitted that it had overreached in **designing** the Model X, and has tried to build a simpler vehicle with the Model 3, said Hartmann.

## Challenges of Scale

As **Tesla** ramps up deliveries of the Model 3, it could find its current distribution model inadequate, MacDuffie suggested. “**Tesla** has tried to avoid setting up traditional dealer franchises,” he said. “Nobody likes buying cars from a dealer, but dealers also traditionally sell used cars, do servicing [and] provide parts and financing.” Dealers also invest in the inventory of vehicles and thereby absorb some of the risk if sales fall short of expectations, he noted.

**Tesla** so far has outsourced repairs and maintenance, and sales of used cars, but that model may work for a startup and not a company that grows bigger, said MacDuffie. “One speculation is **Tesla** is fighting hard against the franchise dealer model now, but once — and if — it grows big, it may find [itself] yearning for some of the [benefits] that the franchise dealer model provides,” he added. Hartmann agreed, and said that at some point **Tesla** may decide to go down that route.

Musk explained **Tesla**’s model of company-owned stores and service centers in a blog post in 2012 that may hold true even today. “In many respects, it would be easier to pursue the traditional franchise dealership model, as we could save a lot of money on construction and gain widespread distribution overnight,” he wrote. “[However], existing franchise dealers have a fundamental conflict of interest between selling gasoline cars, which constitute the vast majority of their business, and selling the new technology of electric cars. It is impossible for them to explain the advantages of going electric without simultaneously undermining their traditional business. This would leave the electric car without a fair opportunity to make its case to an unfamiliar public.”

Reed did not expect **Tesla** to be forced to change its strategies and embrace the dealer model as it scales up. “These customers will acquiesce to whatever **Tesla** wants them to do,” he said, betting on the company’s customer loyalties.

“What will a high-wealth individual who paid \$70,000 or more [for a **Tesla** car] think when he sees these \$35,000 versions?”—Americus Reed

## Changing Old Ways

According to MacDuffie, another hurdle for **Tesla** as it scales up is that it is vertically integrated and prefers to make most of its parts instead of outsourcing them. Making parts in-house would be harder to do at scale, although its vehicle batteries will be produced at its Gigafactory in Sparks, Nevada, that is expected to begin production in 2017. “Managing an outsourced supply chain, while very common in the auto industry, would be new for **Tesla** and bring coordination complexities.”

The limitations of the charging infrastructure for electric vehicles could prove to be another hurdle, said MacDuffie. He noted that Ghosn had identified the inadequacies of the charging infrastructure acting as a ceiling on the sales of electric vehicles. However, if the market grows to an attractive size, he expected public-private investments in setting up charging stations.

**Tesla**’s record of delaying deliveries beyond the promised dates could be another small worry if that persists. Hartmann noted that Musk has hinted at sticking to targets with the Model 3, but still “there is probably some uncertainty around the delivery date.” For example, **Tesla** began bookings for the Model X in February 2012, but postponed deliveries first from early 2014 to late 2014, and then to mid-2015 before deliveries began in the third quarter of 2015.

MacDuffie, too, said he expected delays in deliveries of the Model 3. However, he expected those missed deadlines to cause no more than a shuffling of customers between the Model 3 and other **Tesla** models. Would it hurt **Tesla**’s reputation at some stage? “At some point it would, but it would have to be a disastrous failure as opposed to just a slow rollout,” he said.

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