Business Strategy &
Beyond Market Constraints

Taft College Foundation – Mini-Leadership Summit
May 2017

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Innovating in an Established Market

TESLA MOTORS

Model S

Model X
The U.S. Dealership Distribution System

- First car dealership established in 1898 to sell steam automobiles from General Motors Corp.
  - Manufacturers tried many distn systems, settling on franchises.
  - Why use a franchise system?

- Do these reasons still apply today?
  - Number of dealers today: approx. 18,000.
  - Number of dealers peaked at 53,125 in 1927.
Auto Distribution: Party Like It’s 1898

- There has been minimal innovation in the automobile distribution system in the U.S.
  - Dealer network not dissimilar to what it was in 1898.

- In the U.S. today:
  - Manufacturers do not sell direct to consumers.
  - No made-to-order business plans in automotive industry.
  - Only online presence is bricks-&-mortar dealers or lead generators who direct buyers to dealers (e.g. autobytel.com; carsdirect.com – lead-generator & partial vertical integration)
  - ... except Tesla.
Innovation in Auto Distribution

- Innovation in distribution rampant in other industries:
  - Retail and Big Box Stores: Wal-Mart.
  - Personal computers and Made-to-Order: Dell.

- Why has the car distribution system persisted?

- Because it is efficient?
  - No – very inefficient system: double-marginalization, sales commissions, inventory costs, shipping costs, etc.
  - E.g., value of new car inventory about $100 billion with annual carrying cost of $890 million (2008).

- Because consumers like buying from dealers?
  - >70% (and ↑) of new car buyers begin research online.
  - >70% of consumers say they’d prefer to “buy direct from manufacturers even if it didn’t save any money.”

- Because U.S. manufacturers don’t know how to innovate?
GM’s Made-to-Order Chevrolet Celta

- Direct internet sales model .... in Brazil.
  - Time from configuration to delivery: 1 week.
  - 20 “build combinations” available.
  - GM uses 50% fewer parts & 60% fewer suppliers.
  - Prices 6% lower – 700,000 sold in first six years (2000-06).
  - GM doesn’t offer this sales channel in the US.

The Celta Sales & Distribution Strategy...A New Economy Model

The Celta will be sold starting the third week of September. Simultaneously, GM do Brasil and its dealer partners are preparing to rollout in stages over the next several months a new internet sales channel based on four key strategies: (1) e-commerce, (2) one price, (3) direct invoicing and (4) fast delivery to the customer.

"Together with our dealer partners, we have stepped out of our comfort zone and broken ground so that Brazilian consumers can have the right car, at the right place, at the right time and at the right price," said Joseph DaMour, General Director, Sales & Marketing, GM
Why No Innovation?

- One reason there has been no innovation in the US is because it is *illegal* to innovate!

- To sell a car in *any* state in the U.S. you have to be registered as a dealer (requires physical location).

- In many states, the manufacturer is prohibited from acting as a dealer (31 states, including Texas).
  - Restrictions on competing with independent dealers in all states.
  - e.g., Chrysler in Los Angeles: “banner” showroom, sub-market rent.

- In many states it is illegal to sell a car over the internet unless licensed as a dealer (and have a physical location).

- Example: GM was listing used cars (off lease) on a website. Purchase was through a TX dealer who received a commission.
  - Texas regulators had the website shut down.
  - Ruling was that website constituted a dealership.
Car Deals on Groupon

■ September 2010:
  ■ 200 Mercedes for $20,000 – 33% discount.
  ■ Illegal in the US!
Does this Matter to the Established Car Industry?

- Yes!

- Why the difference?
- Legacy dealerships are a significant strain on the competitiveness of the U.S. car industry.
  - 2nd mover advantage!
  - Dealer restrictions shape the market for new cars.
  - Implication: If you can change the law, you can change the market (to your adv)

**Table 2**

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Why So Many Restrictions on Selling Cars?

- Restrictions on selling cars exist because dealers want them.

- Manufacturers **oppose** the restrictions.

- Just how powerful are car dealers in America? ...
Dealers vs. Manufacturers?
Who wins?
Dealers win!!

Why Bankruptcy Is the Best Option for GM
Chapter 11 would better preserve the valuable parts of the company than an ad hoc bailout.

By MICHAEL E. LEVINE

General Motors is a once-great company caught in a web of relationships designed for another era. It should not be fed while still caught, because that will leave it trapped until we get tired of feeding it. Then it will die. The only possibility of saving it is to take the risk of cutting it free. In other words, GM should be allowed to go bankrupt.

Consider the costs of tackling GM’s problems with some kind of bailout plan. After 42 years of eroding U.S. market share (from 53% to 20%) and countless announcements of “change,” GM still has eight U.S. brands (Cadillac, Saab, Buick, Pontiac, GMC, Saturn, Chevrolet and Hummer). As for its more successful competitors, Toyota (19% market share) has three, and Honda (11%) has two.

GM has about 7,000 dealers. Toyota has fewer than 1,500. Honda has about 1,000. These fewer and larger dealers are better able to advertise, stock and service the cars they sell. GM knows it needs fewer brands and dealers, but the dealers are protected from termination by state laws. This makes eliminating them and the brands they sell very expensive. It would cost GM billions of dollars and many years to reduce the number of dealers it has to a number near Toyota’s.
Which group can beat (politically) the car dealers?

How about the US Army?

Result?

- The dealers won.

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The Honorable Christopher Dodd
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

I am writing regarding the legislation before the Senate which would establish the Consumer Financial Protection Agency (CFPA) and delineate the limits of its authority.

I understand that an amendment may soon be introduced that would exempt automobile dealerships from any financial oversight under the CFPA. The Army would have strong concerns with any such amendments.

Over the years, many of our Soldiers have fallen victim to predatory lending practices and have entered into contracts for prohibitively expensive financial products promoted by some unscrupulous car dealerships and lenders. Though the Army does educate our Soldiers about buying cars in our normal financial education curriculum, the fact remains that junior enlisted Soldiers — many of whom are drawing a regular paycheck for the first time in their lives and are inexperienced in financial matters — remain an easy target for dishonest brokers. We owe them the protection and oversight that would be afforded by the CFPA.

In an era of persistent conflict and multiple deployments, our Soldiers and their Families are under increasing stress. In surveys conducted by the Department of Defense, finances rank among the primary causes of stress for most military Families. As auto loans are often the most significant financial obligations of our Soldiers — particularly within the junior enlisted grades — we believe that greater government oversight of auto financing and sales for our Soldiers will help protect them and reduce unnecessary financial strain on our already overburdened Army Families.

Soldiers who are distracted by financial issues at home are not fully focused on fighting the enemy, thereby decreasing mission readiness. Protection from unprincipled auto lending enables our Soldiers to concentrate on their primary mission — protecting our great Nation.

Thank you for your continued support of our Soldiers and their Families.

Sincerely,

John M. McHugh
Limiting Supply (or not working so hard)

States restricting Sunday car sales

States in darker shade of blue ban Sunday auto sales outright. Lighter-shaded states have the following restrictions:
Maryland allows Sunday car sales in only counties of Prince George's, Montgomery and Howard.
Michigan restricts Sunday sales to counties with less than 130,000 people.
Texas and Utah prohibit car sales over consecutive weekend days.

Map image: CC/Wikimedia/Theshibboleth
Understanding Political Power

- Why do the car dealers get to impose restrictions?
- Restriction are the product of political competition.
- ... and car dealers are "politically powerful"
- Our question: What does it mean to be “politically powerful”?
- Political power comes from giving politicians what they want.
- What do politicians want?
The Politician’s Hierarchy of Needs

Without being reelected the politician cannot achieve any other goals.

In order to advance up the electoral or party ladder politicians must create new constituencies and alliances with other members of their political party.

Politicians are often elected because of their moral and ideological positions. When reelection does not loom too large these concerns will often determine behavior.
The Sources of Political Power

- Politicians need votes (whatever their true motivation).

- Need to identify voters who care about an issue
  - ... and care enough to change their vote based on decision.
    - Politicians are always accused of taking “____” voters for granted.

- Who cares enough?
  - Those directly affected – does your job depend on policy?

- Everyone else needs to be convinced. Politician needs:
  - Money: donations pay for advertising (= jobs!!).
  - Information/framing: Popular causes (= jobs!!).
The Power of the Car Dealers

- The car dealers:
  - Deliver a lot of jobs ... but more than the manufacturers?
  - Don’t have the most money (they are barely profitable nowadays).
  - Have a good message: jobs, small business, ...
    - But not as good as the US Army!
    - Economic arguments (truth!) are not on their side.

- ... but they have the best combination of these things.
- ... they are entrenched (defending the status quo).
- ... and they have two other advantages:
Advantage #1: The Power of Coverage

- Politicians seek votes ... but not all votes are equal.
  - *(what happened to one-person, one-vote?)*

- *Which votes matter more?*

- Not just “which” but “where”.
Coverage: The System Matters

Two Countries: Green and Blue
Each elects a 10 member legislature.

- Plurality rule, 10 districts
- Proportional Representation (PR), one grand district

→ Concentration vs. Numbers

Ford, GM, Chrysler

Mercedes, BMW
Evidence from Europe

- Car industry was exempt from competition law until 2002
  - “block exemption” expired 30 September, 2002.
  - Ex: Fiat Marea pre-tax price £9,197 in UK, £5,583 in Denmark.

  - Dealers now allowed to open showrooms anywhere (exclusive territories removed).
  - Expected welfare gain of €9-11 billion per year.
  - Dealer market has contracted but the market still evolving.
  - Realized welfare gain is positive.
The Source of Political Power

- **Facts:**
  - 20% of state sales tax revenue comes from car dealerships.
  - Car dealerships account for 7-8% of retail employment.
  - Car dealerships in every population center in the country.
    - i.e. in every electoral district.

- **Levels of political protection:**
  - Car dealerships have federal statutory protection.
  - Even stronger protection at state level.
    - No sig. opposing interests at state level (i.e., manufacturers).

- Not all votes are created equal!
Advantage #2: The Importance of Collective Action

- The car dealers other big advantage?
  - They turn up.

- Beyond manuf. the big loser from sales restrictions is: you!

- When did you last protest to an elected representative?
  - How much effort would you put in? Send an email?

- Jobs, money, framing doesn’t matter if you don’t turn up.

- Solving collective action problems can be difficult...
Collective Action and the Prisoners’ Dilemma

- Two elements:
  - Cooperation is *valuable*
  - Cooperation is *problematic*

- More formally:
  - each player’s choice of his or her dominant strategy (i.e., for whichever strategy the other player might choose, we will choose one particular strategy) results in an outcome that is worse for every player than if they all chose another alternative.

- How can we assess the likelihood of collective action?
Collective Action Checklist

*Collective action is more likely if:*

- Stakes are high (e.g. farm subsidies)
- Groups are small (e.g. producers versus consumers)
- Issue comes up frequently (e.g. car safety)
- Members of interest group share many common interests (e.g. unions, AARP)
- Interest can free-ride on existing organization/network (e.g. NIMBY, unions and trade policy)
- Issue is newsworthy - the media can solve collective action problems
Organizing Coalitions

- Key challenge in politics – forming coalitions

- Coalitions of potential allies do not always form spontaneously
  - Lack of information
  - Cost of organization

- Businesses can be a critical catalyst for beyond-market coalitions.
Takeaways I

- 5 main sources of political power:
  - Direct votes: jobs!
  - Money.
  - Coverage.
  - Solved collective action problem.
  - Information/Framing: A good message.

- The source of political power is identifiable.
  - It can be measured.
  - It can be built and it can be countered.

- Succeeding in a market means building market power and beyond-market (political) power.
How Do Dealer Restrictions Affect Market Entry?

- How does Tesla shape its market strategy to deal with beyond-market constraints?
  
  - *Does Tesla want or need independent dealers?*

- To sell cars in California:
  - Tesla registered as a dealer.
  - Can’t compete with independent franchisees.
    - Fortunately doesn’t have any!
  - *A last mover advantage?*

- *What about other states?*
Retail Innovation by Regulation

- What about states where a manufacturer can’t be a dealer?
  - Should Tesla take on independent dealers?
  - Should Tesla lobby to change the law?
    - Does Tesla have any political power?
  - Should Tesla “do an Uber”?

- Tesla opted to conform to the law
- ... but test its limits.

- Step 1: Tesla opened “galleries” in select states.
Retail Innovation by Regulation

- Step 1: Tesla opened “galleries” in select states.
  - Can’t purchase from galleries. Sales through Tesla head office.
  - Can’t do repairs at galleries – constitutes “dealer behavior”.
  - In Texas (Houston & Austin) galleries employees cannot:
    - Discuss purchasing, financing, or leasing a Tesla.
    - Tell customers the price of a Tesla or how they might reserve one.
    - Offer test drives.
    - Refer customers to an out-of-state store that does any of those things.
  - Colorado showroom currently under investigation by Colorado Dealers Association and Colorado regulators.
  - Tesla can’t sell to some states.

- Step 2: For internet sales, Tesla ships by 3rd party (Tesla argues the transaction is then in CA).
Regulatory Risk

- Tesla IPO Prospectus, 2010:

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

    The foregoing examples of state laws governing the sale of motor vehicles are just some of the regulations we will face as we sell our vehicles. In many states, the application of state motor vehicle laws to our specific sales model is largely untested under state motor vehicle industry laws, particularly with respect to sales over the internet, and would be determined by a fact specific analysis of numerous factors, including whether we have a physical presence or employees in the applicable state, whether we advertise or conduct other activities in the applicable state, how the sale transaction is structured, the volume of sales into the state, and whether the state in question prohibits manufacturers from acting as dealers. As a result of the fact specific and untested nature of these issues, and the fact that applying these laws intended for the traditional automobile distribution model to our sales model allows for some interpretation and discretion by the regulators, the manner in which the applicable authorities will apply their state laws to our distribution model is unknown. Such laws, as well as other laws governing the motor vehicle industry, may subject us to potential inquiries and investigations from state motor vehicle regulators who may question whether our sales model complies with applicable state motor vehicle industry laws and who may require us to change our sales model or may prohibit our ability to sell our vehicles to residents in such states. 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. Such challenges, if successful, could prohibit our ability to sell our vehicles to residents in such states.
Shaping a Market Strategy

- Tesla has pursued an “conform-and-test” strategy.
  - Conform: not open company-owned dealerships where prohibited.
  - Test: sell over the internet where not expressly prohibited (a legal gray area)

- They’ve had some victories (fortune favors the brave!):
A State by State Fight

Elon Musk
@elonmusk

New York judge just ruled in favor Tesla, dismissing the legal attack by auto dealers to prevent direct sales!

11:03 AM - 11 Apr 2013

586 RETWEETS 352 FAVORITES

- Victory is step-by-step ...
Tesla is now fighting direct sales restrictions in North Carolina

Tesla, BMW partner Demmel bringing 50 jobs to Henderson

The move to sustainable transportation is an essential step in the evolution of humans to live in a way that does not destroy the world around us. I have driven over 35,000 miles in my Tesla Model S, and all the electricity (with the exception of road trips) has come from sunshine collected by the solar panels on the roof of my home. – Lellani Munter
How is this playing out across the country?
Free-Market Cheerleader
Chris Christie Blocks Tesla
Sales in New Jersey

By Will Oremus

Gov. Chris Christie, champion of the free market except when it hurts the car-dealership lobby.

Like a lot of Republicans, New Jersey Gov. Chris Christie likes to talk about how the government should get out of the way of the free market. In a speech last week in Washington, D.C., he railed against President Obama’s economic interventions. “We don’t have an income inequality problem, we have an opportunity problem in this country because government’s trying to control the free market,” he said. And he urged his fellow conservatives to shout their opposition to government regulations from the rooftops. “We need to talk about the fact that we’re for a
Why “huge”? Dynamic implications: How will political power change over time?
Two Years Previously

Where you can buy a Tesla

Tesla Motors wants to sell cars directly to consumers, but auto dealers and many state regulators are fighting it. Tesla locations in states where direct sales are prohibited can only serve as showrooms.

Sources: Tesla, National Automobile Dealers Association

Map: CNNMoney
"If we're seeing nonstop battles at the state level, rather than fight 20 different state battles, I'd rather fight one federal battle." Musk told Automotive News last week.
Tesla repays federal loan nearly 10 years early

By Chris Isidore @CNNMoney May 22, 2013, 4:51 PM ET

NEW YORK (CNNMoney)

Tesla Motors announced Wednesday that it has repaid a $465 million loan from the government nearly a decade before it was scheduled to do so.

The electric-car maker received the loan from the Department of Energy in January 2010, and it made its first payment this past December. That began what was supposed to be a 10-year repayment program, but plans have changed.

Tesla (TSLA) reported its first quarterly profit earlier this month, and Consumer Reports came out with a review calling the Tesla Model S the best car it ever tested. Those two facts, along with a significant short squeeze, helped send the stock soaring to record highs.
Can the battle be moved to federal level?

Tesla Motors White House petition passes 100K signatures — a small win for electric cars?

A White House petition to make it legal for Tesla Motors to sell its revolutionary cars directly to consumers surpassed its goal of 100,000 signatures today — meaning it'll get an official response from the Obama administration.
Strategy Question

- Should Tesla “venue switch” to Federal level in US?
  - Are they better off with one national fight rather than 50 individual fights?

- What factors determine your answer?

- Question: At which level does Tesla wield the most relative political power?
The chance Congress will act is approximately zero.

- Tesla’s “coverage” at Federal level is terrible!
Does Tesla Really Need a $5 Billion Battery?

Musk Seeks Sites in Southwestern States for Giant Factory

In a project that is befuddling industry experts and competitors, Tesla Motors Inc. (TSLA -5.85%) is looking for possible sites for a giant electric-car battery factory in four Southwestern states.

The plant, dubbed a “gigafactory” by Tesla Chief Executive Elon Musk, would be the world’s largest factory by a long shot. Mr. Musk has outlined a proposal to spend $5 billion on it, hiring up to 6,500 workers and creating thousands of ancillary jobs. He compares the undertaking to auto-industry pioneer Henry Ford’s early 20th century Rouge complex. It took in iron ore and other raw materials at one end and rolled out completed Model Ts at the other, aiming to control and cut costs at every stage of production.

Mr. Musk wants to begin making batteries at the plant in 2017, a timeline that puts pressure on the company to break ground this year. Tesla executives say they need the Gigafactory to guarantee the supply of millions of battery cells and to cut costs through scale and logistics savings.

Meanwhile, officials in Arizona, Nevada, New Mexico and Texas are trying to lure the Silicon Valley-based maker of electric cars to their state. Mr. O’Connell and other Tesla officials are in the final stages of vetting sites in those states.

In Texas, Gov. Rick Perry is said to be leading negotiations directly. He told Fox Business last week that he could support overhauling state laws that block Tesla from operating company-owned retail car stores so the Gigafactory and its jobs don’t go elsewhere. “The cachet of being able to say we put that manufacturing facility in [our] state is hard to pass up,” he said.

In Arizona, legislators are pushing through bills to allow Tesla to sell cars without franchised dealerships. New Mexico may call a special legislative session to create incentives for the factory. And Nevada, which is rich in natural resources like lithium and the closest to Tesla’s car factory in the Oakland suburb of Fremont, Calif., has already had Tesla officials visit Reno to look at sites.
Take-Aways II

- Markets are not shaped by market factors alone.
  - Govt policy often determines the rules-of-the game for market competition
  - ... and who wins and loses.

- The “rules” are the result of beyond-market competition.
  - The rules are not always sensible and they are rarely fair.
  - The rules of the game + market strategy determine performance.

- Political power can be measured, just like market power.
  - Beyond-market power (just like market power) can change: Think dynamically!

- Requires an Integrated Strategy: Market strategy + beyond market strategy should be complementary.