

Škoda Auto: A recommendation for driving growth in North America

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2015

Bachelor of Commerce Best Business Research Papers

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Original citation:

Scott, D. (2015). Škoda Auto: A recommendation for driving growth in North America. *Bachelor of Commerce Best Business Research Papers, 8*, 88-98.

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Škoda Auto:

A recommendation for driving growth in North America

David Scott
Fall 2014

ABSTRACT

This paper discusses Škoda's goal to sell 1.5 million cars annually, and suggests entry into North America as a means to achieve that goal. By looking at Škoda itself, the paper finds that the company is well suited for entry into a new market because of a recent rebranding, solid financial management, and a successful entry into the Asian market in the recent past. Looking at the North American market, there is a theme of growth. It is also discovered that the market is fragmented, a trait which lowers barriers to entry. A SWOT analysis and CAGE framework also illustrate the potential success of a move into North America, while pointing out some challenges that must be addressed for a successful entry; these include regulatory policy, production and shipping logistics, as well as currency uncertainty. Finally, a survey shows that Škoda's offering fits well with the demands of the customer, but that a miscommunication or lack of knowledge of brand image may hinder Škoda's efforts. Finally, the paper concludes that entry into a new market is the best decision for Škoda.



INTRODUCTION

"When you stop growing, you start dying."¹ While William S. Burroughs may not have had multinational corporations in mind when writing this quote, its sentiment is of great importance to today's big businesses. The manifestation of this reality can be seen in the auto market, where, by and large, companies release a new model of their vehicles every single year. While this practice can be considered as a ploy to increase revenues, the point remains that none of the major auto companies are able to stop innovating, as to do so would be to stop competing. One person who understands this trend is Škoda Chairman, Prof. Dr. h.c. Wilfried Vahland, who wrote "in the auto industry, standing still means moving backwards."² Vahland demonstrated this state of mind in the very first sentence of the foreword to Škoda's 2013 annual report, praising Škoda's introduction of "eight new or completely revised models." Vahland goes on to briefly acknowledge the company's success before setting his sights to the future, and a projected long term goal of 1.5 million cars sold annually³. While Škoda has been incredibly successful since the turn of the millennium, its current growth rate, which will be hard to sustain, would only see the realization of this goal in 2021. With that in mind, this report will focus on a proposed entry into the North American market as a means of achieving Škoda's growth target. This report will evaluate the proposed market entry in three sections: first by examining Škoda itself, then evaluating the North American market and finally a SWOT and CAGE framework analysis, augmented by the results of a survey conducted for this paper. These findings will culminate in market entry strategy recommendations.

EXAMINING ŠKODA

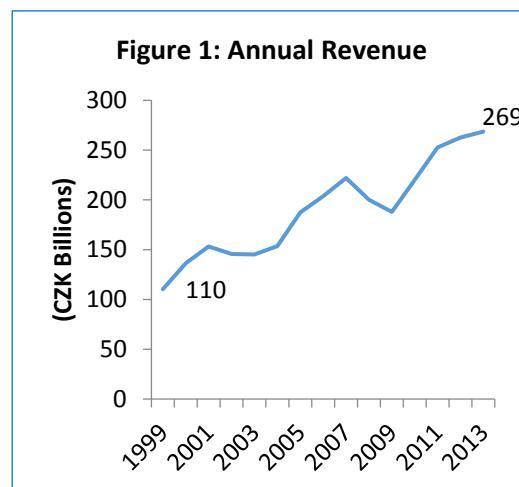
History: 1895 to Today

Škoda has come a long way from its roots as a Czech producer of bicycles under the name Laurin & Klement in 1895⁴. Despite its beginnings outside the field of automobiles, Škoda wasted no time transitioning into the market. The company began production of a motorized bicycle in 1898 and its first automobile in 1905, making it the third oldest manufacturer of cars in the world. Fast forward 20 years, and Laurin & Klement merged with another Czech company, Škoda Works, in order for both businesses to strengthen their position in the market⁵. This new company retained the name Škoda, and keeps it to this day. In 1945, Škoda was nationalized, a result of Second World War and the introduction of communism in what was then Czechoslovakia⁶. Following the fall of communist rule in Czechoslovakia in 1989, the government sought to privatize Škoda, eventually choosing Volkswagen as the company's new owner. In 2012, Škoda reached a production milestone of 14 million cars, nine million of which were produced under Volkswagen ownership⁷. The fact that almost 65% of Škoda's total output has been achieved since the acquisition by Volkswagen illustrates the company's recent and rapid growth, a result of Volkswagen's immediate modernization of the Czech automaker. Today, Škoda is a truly international brand, operating in 103 global markets⁸, and manufacturing vehicles in both Europe and Asia.

Growth

With the exception of a brief stagnation period from 2001, and a hit from the financial crisis of 2009, Škoda has exhibited excellent top line growth since the turn of the millennium (see Figure 1). Compound annual growth measures 6.5% over the past decade and a half, despite the previously mentioned setbacks.

These boosts in revenue can largely be attributed to three factors: an expansion of product line, a successful rebranding campaign, and perhaps most importantly, a successful entry into the Asian market. Looking at the product line, Škoda has tripled their offering from three models in 2000, to nine models at the end of 2013. What significantly impacts revenue is not only the additional choices given to customers, but the new customers that are reached in different market segments. While this expansion of product line has been a big help to Škoda's growth, it would not be possible without the successful rebranding campaign that moved Škoda away from its reputation as a low quality brand. Finally, as seen in Figure 6 (below), Škoda's presence in Asia has exploded in the past decade – this will be discussed in more detail later.



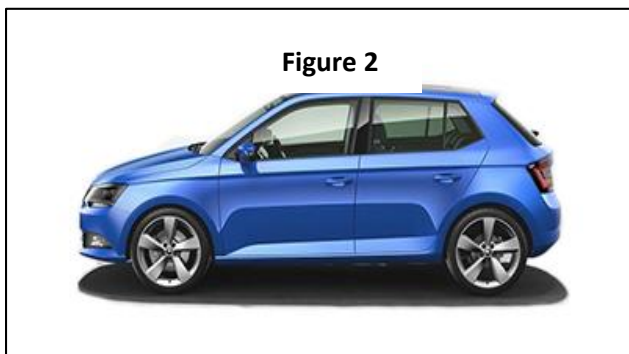
Source: Skoda Annual Reports

Product Line

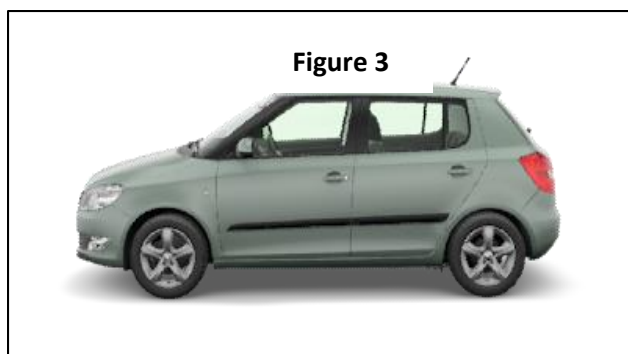
As was mentioned earlier, Škoda has been expanding their product line. This expansion originated in 2010, where Škoda implemented a strategy that involved the introduction of a new or redesigned model every six months⁹. While all of these models are unique, Škoda has focused them all around a key theme of being “timeless, elegant, spacious, high practicality cars that offer excellent value for money”¹⁰. Škoda's product offerings can be segmented into two offerings: small compact cars and mid- to upscale sedans. This report will focus on three models of interest for entering the North American market, the Fabia, the Octavia, and the Rapid.

Fabia

The Fabia (Figures 2-3) is a compact model similar to a hatchback, and is an established model within the Škoda family. Currently, the Fabia is the company's second most popular model in terms of sales, with over 200,000 sold in 2013¹¹. This number, however, is a significant decline from the 240,000 sold in 2012, with the decline being attributed to the model nearing the end of its generational lifecycle.



Source: Skoda Official Website



Source: Skoda Official Website

A new generation of Fabia is expected to rejuvenate the sales of this model in 2014¹². The combination of this model's extended success in the marketplace and the expectation that a new and improved design will come in 2014 makes it a prime candidate for penetrating the North American market.

Octavia

The Octavia (Fig. 4) is Škoda's top seller, accounting for more than 30% of the company's sales in 2013. Similar to the Fabia, Octavia sales were down from 2012. The difference between the two is that a new generation of Octavia was introduced in 2013, and the decrease cannot be blamed on a lack of innovation. Škoda attributes this decline to the phasing out of the old generation, and the inability to meet demand due to capacity reasons¹³. Time will tell whether or not the new generation will surpass the old in terms of popularity, but it is likely to remain as the sales leader by a comfortable margin. This, coupled with the fact that the most popular car models on the American market are sedans suggests that the Octavia has the potential for success.



Source: Skoda Official Website

Rapid

The Rapid (Fig. 5) is a product of Škoda's expansion strategy to include more models in their line-up. Launched in 2012, the model surpassed 100,000 in sales last year¹⁴, without being introduced to the Asian market. Its impending entry, coupled with the introduction of the Rapid Greenline, suggest sales are expected to grow in the coming year. Ultimately, it is the positioning of the Rapid that makes it such a good fit for Škoda when entering the North American market. Potential buyers who are looking to spend less than the money required for an Octavia, and who are looking for more space than provided by the Fabia will find a happy medium in the Rapid.



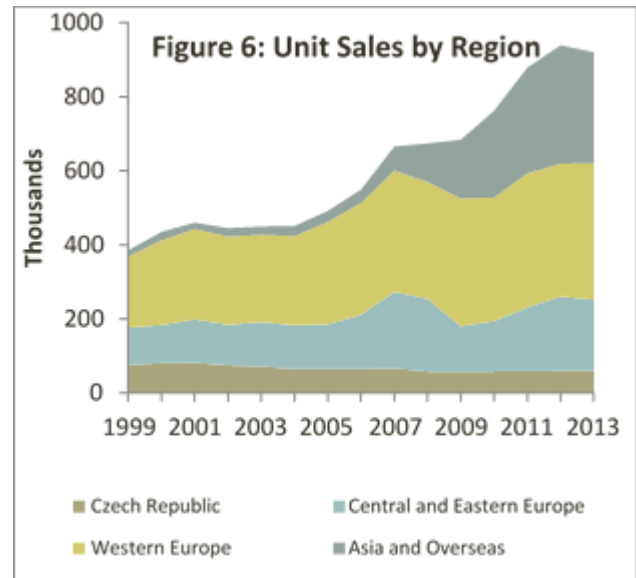
Source: Skoda Official Website

Other Models and Expanded Offerings

While the above three models represent the best trio with which to enter the North American market, there are others which could be successful in the future. Take, for example, the Yeti. This compact SUV offers a mix of space and fuel efficiency, and has been a steady success in Škoda’s other markets. It is a more European take on the SUV (mainly due to its reduced size), but its efficient use of space makes it a practical choice, and its European style separates it from the other models on the market. Its uniqueness comes with challenges, as well. Customers will be less willing to try a new type of SUV, from a company they are not familiar with. Given this fact, Škoda would be better suited in waiting to establish brand recognition prior to introducing the Yeti. Other models, such as the Roomster face similar situations to the Yeti, and as brand recognition increases, so too should product offerings in North America.

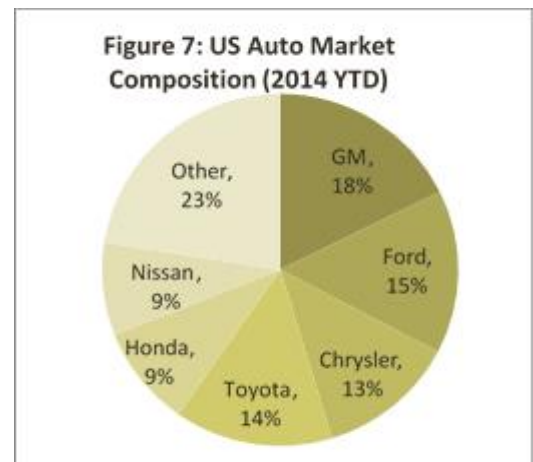
Markets

Looking at the historical sales of Škoda in their four geographical regions, it becomes clear that the company is expanding. This section seeks to analyze each region to see where sales and growth are being generated. In their annual reports, Škoda has typically segmented its sales into four regions, Czech Republic, central and eastern Europe (excluding the Czech Republic), western Europe, and finally Asia and Overseas¹⁵. Given that this is how the data is presented, and that the segmentation is not unconventional, this report will analyze Škoda’s current operations through the scope of these markets. Observing Figure 6, we see that sales have been consistently decreasing within the Czech Republic, from as high as 82,000 in 2002, to 60,000 in 2013. Despite this, Škoda remains a market leader in its home nation, as illustrated by a healthy 31 % market share in 2012¹⁶. Eastern Europe has been slightly more volatile, but has performed well in recent years, with sales in the region accounting for 21% of the company total in 2013.



Source: Skoda Annual Reports

Next is western Europe, a market which has exhibited constant, healthy growth over the last 15 years. In fact, total sales in the region have grown 92% between 1999 and 2013. Currently, western Europe accounts for 50% of total sales. Finally we have the Asian and overseas markets, which have produced booming gains over the last half decade. To be precise, sales in these markets grew at an unbelievable 37.4% compound annual growth rate between the years 2007 and 2012. It should also be pointed out that the majority of this growth occurred during the global financial crisis – with annual growth hovering near 50% in 2008-2010. While this is impressive, Škoda’s 2013 regional sales failed to surpass 2012 numbers, a blunt reminder that the exceptional growth experienced in the past is not to be taken for granted, and not likely to stick around forever.



Source: WSJ Online

Looking at these regions, it becomes clear that Škoda has experience in both successfully entering new markets, and competing in existing ones. What is less clear is if these current markets will be sufficient to help Škoda meet its goal of 1.5 million annual deliveries, a more than 50% increase on current numbers.

Financial Analysis

It is clear from Figures 1 and 6 (above) that Škoda has been experiencing relatively steady top line growth, 6.6% CAGR to be exact, but this tells us little of their financial situation. Looking at profits over the last 15 years, Škoda has not reported losses in a single year, though profitability has fluctuated. In general, profitability has been improving, from near 2% in 1999-2004, to roughly 5% in the past four years. It should be noted however, that during the financial crisis in 2009, profitability fell back to 2%, showing that despite increased sales, Škoda was not completely unaffected by the recession. In the last year, Škoda made 12,816 CZK (\$674 CAD) in profits per sale of each vehicle. The company has displayed solid financial management, maintaining a debt-to-equity ratio of between 0.72 and 0.89 since 2006. This number is significant because it proves Škoda’s ability to foster healthy growth, rather than needing excessive leverage to drive sales. This disciplined management will serve them well when entering the North American market.

THE NORTH AMERICAN MARKET

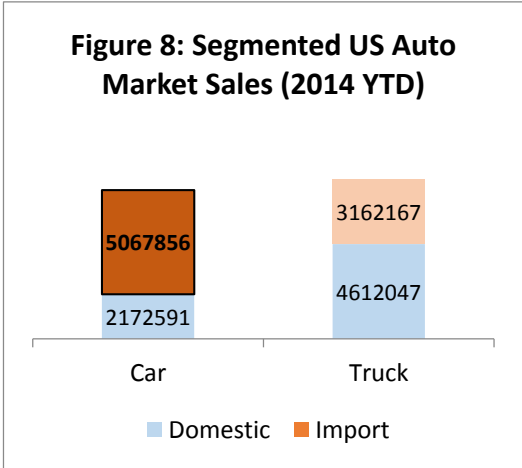
Market Size/Composition

Figure 7 illustrates that the market in the United States is fragmented. What is more interesting is that foreign companies (specifically Toyota, Honda and Nissan) have closed the gap on the domestic competitors. Increasingly, customers are faced with more choices, and it is becoming harder and harder for brands to grow their market share. This trend however, does not affect everyone in a negative way. While increasing competitors does signal a competitive market, it also highlights the fact that new players are able to enter the game, and compete. It should also be noted that Škoda does not need to dominate the North American market; a three percent share of the projected 2014 market would raise their sales to the previously mentioned goal of 1.5 million unit sales.

Major Players

The American auto market is still dominated by three American car manufacturers. As seen in Figure 7, GM, Ford, and Chrysler account for 46% of cars sold in the United States this year. While Toyota, Honda, and Nissan are building their position in the market, the local producers still carry the decisive edge. This data does not account for Canadian trends, but given that the United States carries a population that is approximately ten times that of Canada’s, this paper will focus solely on the larger market.

While the big three (GM, Ford, Chrysler) hold a dominant position on the market, there is hope for Škoda. A large part of these American companies’ success is derived from the sale of pick-up trucks and other truck related vehicles. As seen in Figure 8, import cars dominated their domestic competition, outselling them by more than a two-to-one ratio. In fact, nine of the top twenty vehicle models sold last year were cars, and seven of those models were imports. Of those seven import cars, Toyota and Honda each had two models and the remaining three were manufactured by Nissan, Hyundai, and Volkswagen. Further, no single model held more than 5.5% (Toyota Camry) total market



Source: WSJ Online

share¹⁷. This fact demonstrates the highly fragmented nature of the American auto market, a favourable condition for Škoda's proposed entry.

Trends

No trend regarding the United States auto market is more promising than the fact that for a fourth straight year, it will have grown¹⁸. Similar to past form, this trend will see an elevated sale of pick-up trucks, which will continue to be the most sought after type of vehicle on the market. This trend is interesting, as sales will be exceeding their "demographically supported levels of 15.5 to 16 million"¹⁹ cars per year. To be precise, sales are forecasted to be 16.2 million in 2014, and 16.75 million in 2015²⁰. If the demand exceeds what is to be expected from the demography of the United States, what is the cause? Sonya Gulati and Andrew Labelle of TD argue in their special report (U.S. Automakers Basking in Their Comeback Glow) that pent-up demand is a by-product of the past recession²¹. Given the numbers, it's hard to argue. Auto sales dropped by almost three million units in 2008, and again in 2009, leaving annual sales at near eleven million. Since 2009, sales have flourished. In 2013, sales surpassed 15 million for the first time since the financial crisis²².

Given this resurgence in the size of the American market, it is surprising that the percent of nominal gross domestic product (GDP) spent on vehicles still lags behind pre-recession levels²³. In 2007, the United States spent three percent of GDP on the auto market, and although the market has rebounded, that number was only at 2.7 percent at the end of 2013²⁴. The difference between these two numbers does not seem significant, amounting to only 0.3 percent of GDP. Consider, however, that in 2013 the American GDP was 16.8 trillion US dollars²⁵. Those three tenths of a percentage point now represent over 50 billion US dollars. Assuming that the average car costs \$20,000, that gap represents the sale of an additional two and a half million cars.

SWOT Analysis

Strengths

Škoda is the benefactor of three major strengths that it must leverage in order to be successful in North America: being owned by Volkswagen, being highly regarded in terms of customer satisfaction, and having recent experience entering a new market. First, ownership by Volkswagen bears an advantage in that they have already experienced entering the North American market and are now well established in it (the Volkswagen Jetta is the ninth best-selling car in the United States so far this year). This presence will yield advantages in the form of existing business relationships to speed up the process of entry, and the possibility for economies of scale that would exist with expanded production. These scale benefits will likely manifest themselves within the manufacturing or transportation part of the production chain, though it may be possible to save costs by selling Škoda's at Volkswagen dealerships (assuming there is available capacity).

The second strength comes by way of JD Power. The renowned auto industry surveyor distributed its findings for customer satisfaction in the United Kingdom. Škoda placed fourth. Ahead of Škoda were Jaguar, Lexus, and Mercedes-Benz, none of whom compete in the same segments as Škoda. As an added bonus, Volkswagen ranked fifth. Toyota and Honda also placed in the top 10, while Ford fell below the study average, and Chrysler finished dead last. GM was not ranked.

Finally, Škoda has a positive record when it comes to entering new markets. If the past is the best predictor of future performance, then Škoda's textbook entry into Asia produces great optimism for North America.

Weaknesses

Škoda faces major challenges plotting entry into North America, namely a lack of brand recognition and other logistical challenges that result from not having any current operations. First and foremost, Škoda will need to increase brand recognition. While customers in North America may have heard of Škoda, they are not likely aware of what the company has to offer, nor are they likely to be inclined to trust them. An investment in a car is a big and expensive decision, and customers will want to invest in something they know and trust. Currently, Škoda may not be either of them. The next challenge is that Škoda has no current operations in North America. That would mean that all cars would have to be imported from one of Škoda's factories in Europe or Asia. While imports from Asia are not uncommon among other car companies, Škoda must keep up with growing demand in the Asian market, and could soon face capacity problems. This means that there will likely be a need for a new factory to be built in either Asia or North America. If built in North America, Škoda is exposing itself to a huge capital risk before even entering the market. If built in Asia, Škoda may miss out on savings due to the fact that cars must be transported. While further analysis is needed on the cost structure of those two options, it is outside the scope of this paper, and will not be discussed further. To summarize, Škoda suffers from a lack of brand recognition and operational logistics, two common problems faced by a lack of presence in a market.

Opportunities

Two opportunities that Škoda can take advantage of in the American market are the recent strength of the American dollar, and the more long term trend of a shift towards fuel efficiency. More generally, a big opportunity for Škoda is the growing American market, as mentioned above. The first opportunity, the strong American dollar, represents an opportunity for arbitrage across markets. This can be executed in one of two ways. First, Škoda could simply translate its pricing in euros to American dollars, resulting in a relatively lower price on the market, likely resulting in more sales. Second, Škoda could adjust the sale price to account for the improved purchasing power of the dollar, in order to make higher profits per car. Given that the initial mandate of Škoda is to reach 1.5 million in unit sales, the first approach should be used. The second opportunity to seize on is the recent trend towards fuel efficient cars²⁶. Škoda produces highly fuel efficient cars, with most of their models needing less than four litres of fuel to travel four hundred kilometres. Add to this, an even more environmentally friendly alternative to most of their models (including the Rapid and Octavia) is being produced, and Škoda seems well positioned to fit the market's demands.

Threats

Two of the threats that are most pressing to Škoda ownership are regulatory changes and cannibalization. First, Škoda will be subjecting themselves to a new set of regulations, both in the United States, and Canada. This means that cars will either have to be designed to meet an additional set of standards, or that a new North American version of each model will have to be manufactured to meet regulations. Additionally, as is the case with all markets, if regulations change, Škoda brands may no longer conform and will have to be modified. This can cost both money and production capacity. The second threat is concerned with the cannibalization of Volkswagen's current market share. While the market is highly fragmented, lessening the potential harms of cannibalization, the two brands both strive to offer affordable quality, and will likely be competing for a lot of the same customers. Škoda could consider different branding techniques to separate themselves from Volkswagen, though some amount of cannibalization is almost inevitable.

CAGE Framework

Cultural Distance

As briefly mentioned earlier, customers in North America will likely have different values and preferences when it comes to the cars they prefer. One example of this is size; in general, American cars tend to be bigger. It is very telling that the leading type of car sold in the United States this year is a domestic pick-up truck, considering the fact that pick-up trucks are virtually non-existent in European life, with the exception of work-related vehicles. Another example is fuel efficiency. While fuel efficiency is becoming more and more important world-wide, efficiency holds more weight in Europe, where fuel prices tend to be higher. These preferences are not insurmountable, nor are they inherently negative, but they must be recognized in order to successfully appeal to potential consumers.

Administrative Distance

The distance that has the biggest potential to slow down Škoda's proposed entry is without a doubt administrative. Given that Europe and North America are governed by separate and independent regulatory bodies, vehicles must conform to different safety and emissions standards²⁷. While emissions are likely not a problem, safety standards could cause big issues. If these standards require that Škoda alter their vehicle, compliance could be costly. If this is the case, then a cost-benefit analysis is required to determine if entry will still be profitable given the required alterations.

Geographical Distance

The biggest challenge with respect to the geographic location of the North American market will be transporting and storing the cars effectively and efficiently. First and foremost, it will be costly to ship thousands of cars from either China or central and Eastern Europe. Second, there is a logistical problem to meeting a fluctuation in demand when production happens on a different part of the globe. For example, if demand rises sharply and abruptly, Škoda may not be able to meet the demand of the market, unless they have a stockpile of vehicles somewhere. This stockpile would be inefficient, resulting in extra capital being stored on a lot, rather than being actively invested to improve operations.

Economic Distance

The obvious differentiator between Škoda's home market and the North American market is currency. Fluctuations in exchange rates lead to uncertainty, and can make it more difficult to price a product in the market. For example, if Škoda's offerings are priced lower in the United States to take advantage of the strong dollar, what will happen if the euro strengthens, or the dollar slides? Should Škoda adjust its prices? North American consumers will not be happy with an increase in price, and sales will falter. Measures to guard against fluctuation need to be taken. These can range from alternative pricing decisions to arranging futures contracts for costs incurred by American market operations. A fixed rate on certain costs and contracts will help to ease the uncertainty caused by separate currencies.

SURVEY Analysis

A survey was conducted in December of 2014 to gauge certain aspects of both Škoda, as well as the priorities of potential car buyers. All data and conclusions drawn in this portion of the report have been gathered from the same survey²⁸. The survey contained a total of 24 responses at the time of writing. While the results have been informative, it must be noted that the majority of solicited responses came from University-aged students, and that the survey does not appropriately represent the whole market place.

Priorities

When asked about what they valued most when buying a car, respondents valued price and quality over all else. This is valuable for Škoda, as that is their main initiative, quality for price. If Škoda can drive their value proposition home to consumers, respondents to this survey should theoretically be attracted to the brand. The next most valued trait was brand name. As discussed earlier, this is a challenge for Škoda. But within this challenge, there is an opportunity – six of twenty four respondents did not know about Škoda, and an additional four were not able to share their perception of the brand. This means that Škoda has an opportunity to present itself to those who have not heard of them without the burden of its past negative brand image – something that still haunts them to a degree. The fourth most important trait was fuel efficiency, something that Škoda excels at. As mentioned above, this priority is on the rise, and Škoda will likely benefit from this trend. Rounding out priorities were power and space – two things Škoda is not known for. In conclusion, respondents tend to share the same set of values that Škoda caters to, however the obstacle of brand recognition could hinder their attempt to provide the market with what they have to offer.

Brand perception

Of the twenty four respondents, fourteen chose to describe the Škoda brand in three words or less. While some of the responses were unproductive, two general themes emerged: cheap, and Czech. It is not clear whether cheap is meant with a negative connotation, though that would usually be the case. This suggests that, as discussed earlier, Škoda has not shed its historical stereotypes. Škoda should endeavour to find out if the perceived cheapness of the brand relates to a low quality product that is appropriately priced, or if the product is not perceived to fulfill the value on its price tag. From there, Škoda can alter its marketing approach in order to positively affect brand image. The second theme that appeared was its Czech heritage. This means that the brand will likely be tied to the success of its country. Škoda must decide if they would like to be associated in that way – if so, they should appeal to their heritage, if not, they should promote their makeover.

Competition

The final aspect of the survey asked respondents to evaluate the five largest competitors on the American market (GM, Ford, Chrysler, Toyota, and Honda) in terms of their general perception of each brand. This question was broadly worded in order to gauge the respondents' general feeling towards a brand in order to evaluate how powerful each brand name is. Honda finished first, scoring a 3.58 out of a possible 5. Toyota was second at 3.33, slightly ahead of both Ford and GM who finished at 3.17. Chrysler places last, only receiving a rating of 2.33. The close proximity of the top four brands relative to each other suggests that it is difficult to differentiate a brand, except as Chrysler shows, in a negative way. This means that Škoda should be able to integrate into the market barring any events that largely affect its public image, and it is important to remember that there is no second chance at a first impression, so whatever marketing strategy Škoda implements will have a huge effect on the success of the market entry.

RECOMMENDATIONS AND CONCLUSION

In summation, this paper has explored Škoda as a company, the North American market, and has sought responses to a survey in order to better understand potential customers. All of these endeavours have led to the conclusion that entry into the North American market is a good fit for Škoda, viable and full of potential.

Looking at Škoda as a company, it has experienced growing sales over the past years, especially in Asia, though these sales have declined for the first time in years. It seems as though growth in the Asian market is slowing, and given the growth rates of the remaining three markets, it will be difficult to reach the sales goal of 1.5 million units annually. Additionally, it was observed that Škoda has behaved as a financially responsible company, holding

a stable debt-to-equity ratio during its expansion into Asia. It has also displayed the ability to enter a new market, and with the new branding to shed its old image, the prospect of marketing this brand to a new audience is quite attractive.

In analyzing the North American market, the number one theme is growth. For the fourth straight year, car sales have risen in the United States, and are forecast to do so for the next two years as well. Additionally, when focusing on the segment of cars (as opposed to trucks), foreign imports dominate their local competitors. As a potential importer, this is good news for Škoda.

Finally, having viewed the results of the survey to poll potential Škoda customers, there are both issues to address, and reasons for optimism. First, Škoda did not score particularly well in terms of what consumers had to say about the brand. This needs to change, especially considering that brand image ranked third of six among respondents. On the bright side, what Škoda aims to offer and what customers want are very similar, suggesting a miscommunication among informed respondents or a failure to deliver on Škoda's part. Given the growth exhibited by Škoda after the rebranding, it would seem that the former is the case.

Škoda has a lot of potential in North America, and if it wants to reach its sales goal, the bottom line is that it needs to capitalize on that potential.

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