



Effective Channel Management Is Critical in Combating the Gray Market and Increasing Technology Companies' Bottom Line

Executive Summary

KPMG LLP



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Original equipment manufacturers (OEMs), channel partners, and end customers have long been plagued by the “gray market,” the unauthorized alternative channel where branded products have been intentionally diverted from authorized sales channels into the hands of unauthorized dealers, brokers, or the open market for gain. Unlike products sold through authorized channels, gray market products may pose serious issues for both OEMs and customers alike. Gray market resellers may advertise products as new, authentic, and branded goods, but customers may wind up receiving goods ranging from used or remarketed products to those that have been wholly or partially counterfeited or mislabeled.

Victimized end customers are only one side of the equation. Information technology (IT) companies unwittingly suffer from price erosion, brand damage, and the hidden costs of handling end-customer issues resulting from inadequate customer service, product handling and installation, lack of warranty cover, or other potential discontent with gray market resellers. In a world where the lowest price is often a customer’s top priority, authorized channel partners and resellers are at times unable to compete with deeply discounted gray market products and either lose deals or decide to take a chance and actively participate in the gray market themselves.

For end customers, faced with the sometimes daunting task of discerning which entities are authorized to sell genuine goods and which are doing so through correct channels, a decision based solely on price may be the best bet. But that bet could go awry fast since gray market dealers or brokers are often not authorized to resell these products, nor are they required to uphold the standards of product quality and service generally required by a manufacturer of authorized dealers. As a result of purchasing gray market products from unauthorized resellers, end customers could wind up with major data loss, business interruption, or worse.

Why Does the Gray Market Occur?

If prices move markets, markets often move in favor of the lower-cost alternative. Faced with a competitor undercutting its prices by 25 percent, a company must seek an effective counter-strategy. Sometimes this counter-strategy includes selling products outside authorized channels such as the gray market. And there’s the rub, because branded IT products have to compete with their competitors as well as lower-cost brands and counterfeits of their own products. While channel partners have a clear responsibility to adhere to the terms and conditions of partner programs, the burden falls on OEMs to establish clear guidelines for reselling and enforce those

guidelines. Put simply: Companies must have a strategic solution to counter the gray market issue.

The gray market has many sources. Unauthorized dealers obtain products from a variety of sources normally at a discounted price either due to price arbitrage, abuse of incentive programs, or simply because the products are not what they seem. For example, an OEM may choose to discount products for a particular end customer to increase sales, especially if there is a stiff competition for that customer. To obtain deeply discounted products for open-market speculation, a channel partner may deceive the OEM into deep-discounting products for non-existent customers and then divert those products to the gray market for possibly greater gain. In addition, some brokers may misrepresent themselves in the authorization process and use the resulting relationship to obtain discounted goods that are then diverted into the gray market.

Deception has a negative trickle-down effect, however. Unauthorized brokers have no contractual obligations or costs associated with preserving brand reputation, quality standards, or customer support, so they can sell that product at a lower cost than an authorized channel. For end customers, the lower cost may seem appealing. But they are deceived into believing the products are identical in every way (including warranty cover, service, quality, etc.), and fail to heed the potential downside to dealing with unauthorized dealers—specifically, the hidden high costs of potentially inferior quality, service, and support. Their buying decisions may also result in potential loss of warranty, unauthorized or pirated software or illegal software licenses, and minimum or no service after the purchase (particularly from online brokers). The end result could be business interruption and data loss.

Still, many customers are willing to forgo OEM warranty and support or other inconveniences in favor of the lower price. They are lured by gray market resellers advertising warranties that many times exceed the OEM warranty, which is often a sales pitch without any intent or ability to honor such warranties. If something goes wrong, the customer will seek out the OEM, which may chastise the customer for buying outside of authorized channels. But to avoid brand-reputation damage, the OEM sometimes chooses to provide some support to the end customer. In essence, the OEM is compounding the gray market problem by losing revenue through supporting an unauthorized product.

Some companies believe the gray market is just a cost of doing business, while others argue that the Internet has exacerbated the situation. Companies with multitiered distribution channels can lose control of their products once they enter the second tier. The bottom line: Many OEMs settle for price and reputation-risk pressure.

“There are alternatives to accepting gray market challenges as a cost of doing business. By devising a strategic program, many companies are currently mitigating the losses to the gray market,” said Ram Manchi, president of the Alliance for Gray Market and Counterfeit Abatement (AGMA).

The Survey

Six years ago, KPMG surveyed the IT market regarding gray market issues. Enough time had elapsed to warrant another, more expanded survey. We wanted to see how high technology (“high tech”) companies are currently managing their channels, and if the problem was growing or shrinking. We hoped to find out if the Internet was indeed contributing to the issue of unauthorized resale. We wanted to see if the problem’s perceptions were common to both high tech OEMs and channel partners (first and second tier authorized channel partners, including resellers,

Key Trends

- Most companies now have contractual provisions addressing unauthorized-channel issues
- Many companies have not adopted effective means to monitor their channels for adherence to those provisions
- Companies that have the means to monitor are often reluctant to take strong action to preserve the integrity of their authorized channels and change behaviors that are detrimental to the channel as a whole
- Many companies offer channel incentives that are serial-number dependent
- Many companies either lack the means or do not check serial numbers when processing incentives
- Companies that do track serial numbers are not consistent in the use of this information as it relates to warranty, payment of incentives, and processing discounts
- Both those companies without the means for checking and those that purport to have them end up paying incentives on products that do not qualify
- The gray market continues to be a significant problem for both OEMs and channel partners
- Many companies have bolstered their channel management since our 2002 report was published. But without channel commitment to clean up their part, and without a comprehensive approach to channel management with robust consequence management, these efforts are not solving the problem

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consumer retailers, and system integrators). In addition, we wanted to look at where brokers (unauthorized dealers) fit into the equation. Finally, we wanted to see if any companies had succeeded with gray market counter measures—and why.

Objectives

KPMG had three main objectives in this survey. We wanted to:

- Assess opinions of business leaders at OEMs, channel partners, and brokers about the impact of the gray market on their industries
- Update and expand upon the insights we shared in the 2002 gray market survey
- Achieve a robust, repeatable market-sizing model

We fielded three separate Web-based surveys designed for OEMs, channel partners, and brokers, respectively. The surveys ran from September through October 2007 and involved 189 respondents.

We set about meeting our project objectives based on the data from these surveys, as well as on data from related recent surveys, our own proprietary modeling of gray market impact, and input from the AGMA and MarkMonitor®. This report contains an executive summary, survey findings, and summary sections. After working through the data, against a backdrop of KPMG's experience in helping companies work through various channel-management obstacles and solutions, we were able to distill some significant patterns. We also engaged with AGMA representatives to provide further depth to our analysis.

Recommendations

1. Review incentive programs to identify potential areas of weakness (which could be exploited by channel partners either deliberately or by accident). If they are uncovered, take steps to strengthen them.
2. Issue a comprehensive channel policy that outlines expectations in terms of compliance and reporting. Spell out consequences for noncompliance, and always follow through.
3. Monitor your channel reporting and look for unexplained sales spikes, atypical customers, etc., and put automatic alerts in place. Act on those alerts.
4. Implement a robust process for performing due diligence on new partners and special pricing deals. Ensure new partners are capable of meeting reporting requirements. Before announcing a special pricing deal, make sure that objectives and ways of measuring performance against those objectives are clearly identified and established (including making sure the deal is genuine and the product really goes to the required end user).
5. Give someone in the company the responsibility to manage channel integrity. That function needs to provide ongoing communications, training, and guidelines to channel partners making it very clear how the company will respond to incentive fraud, reporting manipulation, and gray market behavior. Make this person or their team a focal point for communications internally, with the market and with industry groups that focus on these issues, such as AGMA.
6. Implement a channel-partner review program that includes on-site comparison of sales data from their "live" system, with information provided through the POS and/or sent to support incentive claims. Ensure robust consequence management is supported and implemented by executive sales management.

Time for Action

The information technology industry should:

- Include gray market mitigation on the board agenda, and review channel compliance with the audit committee
- Develop a solid strategy and formal policies for appropriate channel management
- Train employees to help avoid gray market problems
- Empower a dedicated compliance function to monitor partner management compliance and consequence
- Ensure that partner strategy and policies keep up with changes to the law on gray market and changes in the channel, e.g., Internet business
- Manage product distribution through effective tools and processes that meet industry leading standards. Consider looking outside the OEM if this is not a core competency
- Integrate POS and incentive claim data to better manage incentive claims
- Understand and take advantage of positive legal protections such as coding product for sale in Europe, etc.

Contacts

KPMG's Advisory Services practice provides our clients with a comprehensive portfolio of services to help you manage gray market challenges. For more information about this study or KPMG's Advisory Services, please contact the following Technology Industry practice leaders:

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KPMG can help OEMs reduce the impact of the gray market and recover losses from noncompliant channel partners through a suite of services, including:

- Channel partner compliance audits
- Gray market sizing and monitoring analysis
- Channel compliance programs design and control enhancement reviews
- Channel strategy benchmarking
- Channel contract reviews
- Custom strategies, processes to protect intellectual property, and leading practices to control counterfeit and gray products

About AGMA

AGMA is a nonprofit organization comprised of influential companies in the technology sector including founding members 3Com Corporation [NASDAQ: COMS], Cisco Systems, Inc. [NASDAQ: CSCO], HP [NYSE, Nasdaq: HPQ], and Nortel [NYSE/TSX: NT]. Incorporated in 2001, AGMA's mission is to mitigate gray marketing fraud and counterfeiting of technology products around the globe. The organization's goals are to protect the authorized distribution channels and intellectual property of authorized goods to improve customer satisfaction and preserve brand integrity. AGMA is open to any technology manufacturer that owns a branded product. For more information, please visit www.agmaglobal.org.

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KPMG's Information, Communications & Entertainment (ICE) practice is one of the firm's most dynamic industry-focused practices, devoted to understanding our clients' unique issues and risks, and bringing dedicated professionals to help with their business needs. Our Audit & Risk Advisory practice helps clients manage risk so they can focus on their core businesses. By intimately understanding each client's business, we can convert information into insights to uncover the hidden opportunities that can help clients improve efficiency and performance.

About MarkMonitor

MarkMonitor is the global leader in enterprise brand protection. The company offers comprehensive solutions and services that safeguard brands, reputation, and revenue from online risks. With end-to-end solutions that address the growing threats of online fraud, brand abuse, and unauthorized channels, MarkMonitor enables a secure Internet for businesses and their customers. The company's exclusive access to data combined with its patented prevention, detection, and response capabilities provide wide-ranging protection to the ever-changing online threats faced by brands today. Unrivalled experience in developing and implementing brand protection strategies—focused on global corporations—has led more than half of the FORTUNE 100 to trust MarkMonitor to protect their brands online. For further information, please visit www.markmonitor.com.

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