



THE GREY MARKET

Grey market sales of
IT products could exceed
\$40 billion annually.

C O N T E N T S

- 1 The Grey Market
- 2 Risks and Rewards
- 3 A Catch-22: The OEMs
- 4 On Both Sides of the Fence: The Distributors
- 5 Paying the Price for Innocence: The Consumers
- 5 Time for Action
 - Redefining the Relationship
 - Contacts

THE GREY MARKET

Most information technology companies are successful thanks to distribution channels that shepherd products from a manufacturer and ultimately funnel them to the consumer through a series of legitimate distributors across the world.¹ But a growing and quite detrimental market exists that can cause unwitting customers to purchase technology products with invalid warranties, some designed for use in other countries—or worse, products containing counterfeit parts. These experiences can erode customer satisfaction and damage brand integrity, causing significant profit erosion for manufacturers.

Welcome to the global “grey market,” where branded products have been diverted from the authorized distribution channel within a country or are imported into a country for sale without the consent or knowledge of the manufacturer. Grey market products are generally sold at lower prices than those offered by authorized distributors. And the pricing differential between various legitimate markets and customers creates an opportunity for brokers² to obtain branded products at discounted prices and move them to markets where they can bring higher profits.

A new research study by KPMG³ shows that grey market products pose a serious challenge to information technology manufacturers and their authorized distributors. The study reveals that IT manufacturers are collectively losing up to US\$5 billion in profits annually—a figure that is growing.⁴ While the grey market affects many industries, including automobiles, consumer products, pharmaceuticals, fashion accessories, and others, this research confirms that computers and related products are among the industry sectors most affected by grey market activity, and information technology products valued at as much as US\$40 billion in sales are passing through the grey market annually.

KPMG in cooperation with the Anti-Gray Market Alliance⁵ researched this startling—and largely unexamined—problem by conducting a survey and reporting the findings to the industry. The study examines grey market issues raised by 11 prominent original equipment manufacturers

(OEMs), 43 authorized distributors and resellers (23 in the Americas, 15 in Europe, and 5 in the Pacific Rim), and 10 organizations engaged in brokerage activities. One or more executives from each company were surveyed. The research covers key aspects of how the grey market is impacting the marketplace and its mainstream players, and provides findings on the size and scope of the problem.

The study reveals that IT manufacturers are collectively losing up to US\$5 billion in profits annually—a figure that is growing.

A key message from the study is that executives and boards should understand how the grey market is impacting their brand integrity, not to mention eroding profits, and scrutinize the controls they have in place to help prevent the damage. In many cases, OEMs stand to identify significant remedies through a careful examination of distribution agreements and distributor practices.

Other key findings from the study include:

- Most OEMs have formal programs to manage their distribution systems, but those programs are challenged to contain grey market leakage.
- The grey market is a convenient source for legitimate distributors to obtain and distribute products, and the predominant number of distributors trade on the grey market.
- Significant price advantages on grey market products drive a number of unwanted behaviors by distributors and brokers.
- A wide variety of incentive program and price protection abuses, as well as warranty program misrepresentations by distributors and brokers, further erode manufacturers’ profits.
- Few OEMs have addressed corporate codes of conduct or employee training specifically focused on the grey market to help quell losses.

¹ Within this document “distributors” refers to all members of an authorized channel, including distributors, resellers, VARs, and so on.

² Brokers are defined as entities that buy and sell original equipment manufacturers’ products without any contractual agreement to do so.

³ KPMG LLP, the U.S. member firm of KPMG International.

⁴ All statistical references in this report are derived from the survey results.

⁵ The Anti-Gray Market Alliance (AGMA) comprises companies in the information technology industry based in the United States that are working to find solutions to grey market problems.

THE GREY MARKET

RISKS AND REWARDS

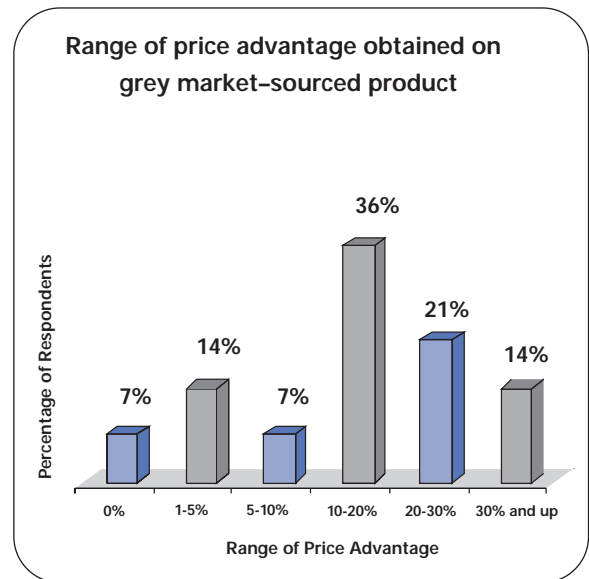
- The majority of companies do not dedicate resources to manage grey market problems.
- Internal audit departments struggle to reach beyond the walls of their companies to validate distribution channel transactions and processes.

The grey market environment is often conspiratorial, with certain players forming agreements to source and move product without the manufacturers' knowledge.

The bottom line: the grey market is hurting legitimate players in the computer manufacturing and distribution network, as well as customers and investors. The threat looms for OEMs and distributors as well as consumers who may think they are buying legitimate products. These unwitting customers may in fact be purchasing technology products with invalid warranties, some designed for use in other countries—or worse, products containing counterfeit parts. These experiences can erode customer satisfaction and damage brand integrity.

Authorized distributors that have made huge investments for the right to sell OEM products are also hurt by unfair competition from brokers who slash prices and move products in violation of OEM distribution agreements.

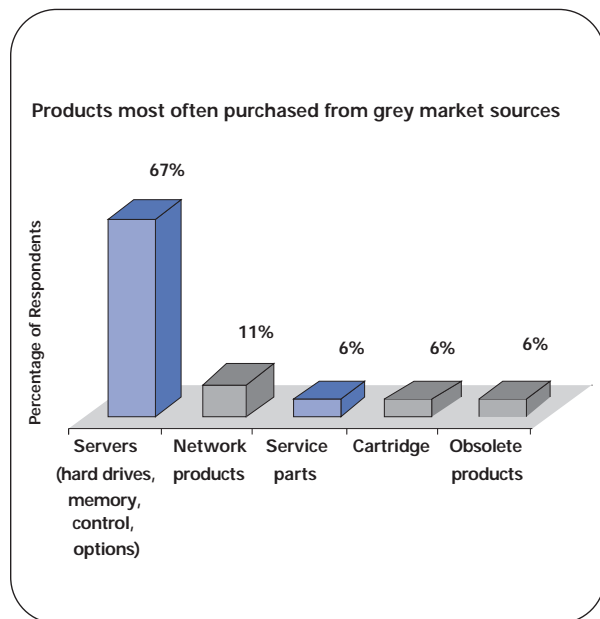
The grey market has its risks as well as its rewards. Despite the pricing differential and the opportunity for high profits, contract violations by distributors and product movement must be hidden from manufacturers. Deceit may be used by brokers or distributors to acquire goods from authorized sources, including misrepresentation of end users' identities in specific discount programs. Also, the grey market environment is often conspiratorial, with certain players forming agreements to source and move product without the manufacturers' knowledge. It is an open door for counterfeit product to enter the authorized distribution channel.



The players in both the authorized distribution channel and the grey market are inextricably woven together, and many have a foot in both camps. These two distribution channels strike a fine balance, providing each other with sources for needed products and a relief valve for bleeding off excess inventory. OEMs, distributors, brokers, and large institutional customers all play an active role in the grey market; however, the individual consumer is rarely aware it even exists.

A CATCH-22: THE OEMS

Respondents to KPMG's survey indicated that OEM products find their way into the grey market in a variety of ways. In some cases, grey marketers take advantage of legitimate discount programs by using fraudulent documentation or other forms of deception to obtain OEM products and then moving them into the grey market. In other cases, authorized distributors may purchase more units for end customers than they ultimately require and may sell them to brokers instead of returning the excess units to the OEM. Additionally, OEMs with excess or end-of-life inventory need to make room for new products. This need can lead to two common grey market triggers: (1) using discount programs designed as an incentive for the authorized network to buy the inventory and (2) moving the product through brokers when legitimate channels are full. The data clearly show that significant price advantages (up to 40 percent) can drive grey market activity.



Grey market activity also drives up secondary costs for OEMs. Consumers who experience quality problems most often blame a product's failure on the manufacturer, potentially decreasing the value of the OEM's brand. In addition, 67 percent of OEMs surveyed continue to provide warranty support for grey market product, further eroding profitability.

All of the OEMs surveyed acknowledge that they have been impacted by the grey market. And, while 87 percent require their distributors to be authorized, there are widely varying contractual requirements for managing the reselling activities of these trading partners. Furthermore, only half of OEMs require controls on the flow of products from their distributors. In fact, the most consistent and indeed the oldest contract clause in a distribution agreement is the definition of a distributor's authorized territory. While they are important and should remain, these clauses alone do not provide effective controls to prevent moving product into the grey market. These and other clauses need to be monitored and enforced to be effective.

Just as electricity seeks the path of least resistance, organizational responsibility for grey market controls is often centered outside a compliance function. All OEMs surveyed said they have resources responsible for grey market issues, but only 33 percent have resources fully dedicated to the task. Not surprisingly, 61 percent place the responsibility in sales and marketing, while only 13 percent charge internal audit with the task.

It is clear from the study that OEMs as a group would benefit from improving both their control environments and contractual relationships with distributors. This might include better contract language and routine compliance audits, in addition to more comprehensive systems for handling transactions between trading partners.

ON BOTH SIDES OF THE FENCE: THE DISTRIBUTORS

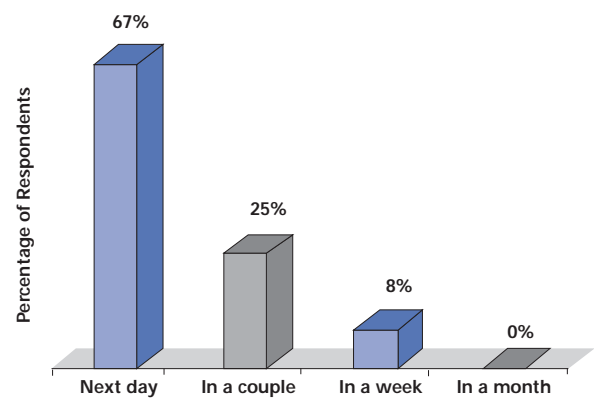
On one hand, the task of achieving status as a distributor is both costly and time consuming. Distributors must meet a variety of tests to obtain the seal of approval from the top brands in the business. On the other hand, the distributor typically sells products for hundreds of manufacturers and works around the clock to generate and fulfill orders.

How many OEM contracts can the distribution partner manage effectively? Does a distributor have controls and systems in place that allow it to comply with its contractual obligations? Is it even possible to consider each clause in so many unique agreements when the game is won or lost on sourcing product immediately on order and fulfilling quickly, often on the same day? While these issues are valid, the distributor still bears a legal obligation to adhere to its contractual requirements. But, at the same time, distributors participate in the grey market to maintain a competitive edge. One hundred percent of authorized distributors surveyed stated they compete with brokers who are able to offer lower prices on identical goods.

Distributors operate their businesses to achieve an average net income of 2 percent. Seventy-one percent claim a price advantage of at least 10 percent from the grey market, while 35 percent of distributors receive price benefits of 30 percent or more.

Moreover, the grey market features significant delivery efficiencies. Some 92 percent of distributors receive products from the grey market within 48 hours, and 55 percent said grey market delivery is faster than OEM fulfillment. On the other end of the supply chain, distributors are motivated to provide fast fulfillment to meet service-level commitments to their end customers.

Delivery time for products purchased from the grey market



Consequently, distributors frequently source from the grey market. Seventy one percent believe it is necessary to purchase product from the grey market, and 41 percent purchase there regularly even though this is a direct contravention of most OEM contracts.

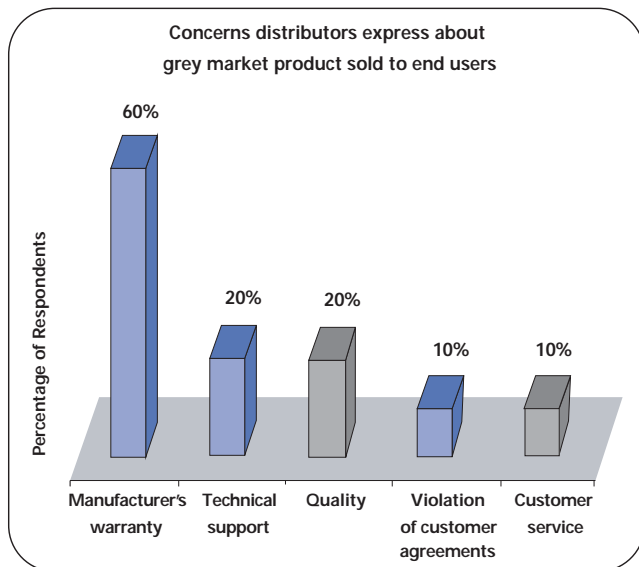
Distributors need to fully understand their contractual obligations and decide whether their corporation condones contractual and ethical violations to achieve profit. Strict adherence to these obligations would significantly reduce the demand for broker-supplied product.

PAYING THE PRICE FOR INNOCENCE: THE CONSUMERS

TIME FOR ACTION

Facing a shelf packed with eye-catching merchandise in any popular computer retail outlet, the average consumer is easily overwhelmed by the number of choices, technical specifications, and price bundles for a given class of products. Yet, under the colorful plastic covers and legitimate packaging may hide components devoid of a valid warranty—or worse, damaged or even counterfeit parts that can cause significant downtime for customers who unknowingly buy these products.

The consumer rarely enjoys a benefit by purchasing products that have traveled through the grey market. Discounts are generally absorbed within the distribution system and survey respondents estimate that 60 percent of end users pay equally for products originating from the grey market and those originating from legitimate channels.



Caveat emptor is the operative adage for consumers of technology products, so OEMs always advise that customers buy product from authorized distributors. And distributors surveyed are concerned that invalid warranties will haunt consumers of grey market products. In addition, they cite a lack of technical support and uncertain quality as secondary concerns.

Clearly, no information technology OEM envisions these unpleasant outcomes when product moves into the grey market channel. So now may be the time to analyze the channel strategy, programs, processes, and controls.

Can the grey market be transformed into a value-added element of the information technology industry? The grey market is a mature and pervasive part of the information technology supply chain, so much so that eliminating it would upset a fairly well-balanced system. However, OEMs are entitled to enjoy both maximum profits from the sale of their products and appropriate use of their sales incentive and warranty funds. To that end, management must take action.

REDEFINING THE RELATIONSHIP

The key lies in improving relationships at all levels in the distribution channel and undertaking sincere initiatives to mitigate the impact of grey marketing activity to help ensure integrity of the channel. Win-win agreements that are uniform across the industry between manufacturer and authorized distributor and designed to limit grey market activity are clearly the place to begin. But contracts are a foundation that can be enacted only through closer working relationships wherein the manufacturer shares in decisions with the distributor about the movement of bulk product deeper into the marketplace.

Further, most respondents to our survey admit they have been impacted by program abuse and fraud, so remedies must be found here also. The Internet may provide a medium for marked improvement in the tracking of individual units and a more secure environment for managing warranty and sales incentive programs than the systems in use today.

Similarly, management of grey market issues is left mainly in the hands of sales and marketing groups where compliance may not be the first order of business. In addition, only slightly more than half of the respondents to KPMG's study use advisers to help perform audits of channel partners. This environment makes it particularly difficult to ensure compliance, considering the symbiotic relationship between manufacturer and distributor.

TIME FOR ACTION

The information technology industry should:

- Place grey market mitigation on the board agenda, and indeed review distributor compliance with the audit committee
- Develop a solid strategy and policies for appropriate use of the broker network
- Train key employees to help avoid grey market problems
- Empower a dedicated compliance function to monitor partner agreements
- Ensure that partner agreements keep up with changes to the law on grey market
- Manage product distribution through tools and processes that meet industry best-practice standards
- Integrate sales and incentive data to better control incentive claims
- Understand and take advantage of positive legal protections such as coding product for sale in Europe to take advantage of new protections in the European Union

KPMG can help OEMs improve their resistance to grey market maladies and recover losses from non-compliant distributors through a suite of services including:

- Distributor compliance audits
- Grey market analysis
- Distribution programs design and control enhancement reviews
- Distribution channel strategy benchmarking
- Distribution contract reviews
- Royalty and license management
- Customs strategies and processes to protect intellectual property and control counterfeit and grey product

CONTACTS

To learn more about how KPMG can help you manage grey market issues, contact Dale LeMasters, U.S. National Partner in Charge—Electronics at +1 650 404 3426 or dlemasters@kpmg.com, or one of the following KPMG country representatives:

United Kingdom

Dick Vincent
Partner
+44 207 311 2524
dick.vincent@kpmg.co.uk

Australia

John Brown
Partner
+61 2 933 57596
jsbrown@kpmg.com.au

Hong Kong

John Zabriskie
Partner
+852 2826 7277
john.zabriskie@kpmg.com.hk

Canada

Peter Doyle
Partner
+1 416 228 7189
pdoyle@kpmg.ca

Germany

Sibylle Bartels-Hetzler
Partner
+49 (0) 89 92 82 1160
sbartlshetzler@kpmg.com

Netherlands

Bert Van den Heuvel
Partner
+31 30 658 2300
vandenheuvel.ber@kpmg.nl

France

Mair Fereres
Partner
+33 1 5568 6918
mfereres@kpmg.com

Japan

Seiya Takahashi
Partner
+81 3 3509 7888
takahashis@kpmg.or.jp

To learn more about the Anti-Gray Market Alliance, contact Marla Briscoe, Vice President, Anti-Gray Market Alliance, at 281-518-7818 or marla.briscoe@hp.com, or visit the Web site at www.antigraymarket.org.

KPMG LLP is the accounting and tax firm that has maintained a continuous commitment throughout its history to providing leadership, integrity, and quality to the capital markets. The Big Four firm with the strongest growth record over the past decade, KPMG offers clients the scale, global reach, industry insights, and multidisciplinary range of services they demand. KPMG LLP (www.us.kpmg.com) is the U.S. member firm of KPMG International. KPMG International's member firms have nearly 100,000 professionals, including 6,600 partners, in 150 countries.

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.



