



BRAND PROTECTION STRATEGIES: Defending Against Gray Market Diversion

EXECUTIVE WHITE PAPER



Kodak

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Executive Summary

In this rapidly changing global economy, gray market diversion has become an ever increasing issue facing many brand owners today. Unlike black market activity—where counterfeit, refurbished, or stolen goods are resold as genuine brand products—gray market activity involves the unauthorized movement of commerce through various geographies by rogue distributors and trusted channel partners alike.

It has been estimated that counterfeiting is reaching \$1 trillion worldwide for all commerce in all verticals combined—roughly 2–7% on average of a brand owners' total revenue. Product diversion is thought to be just as significant and the health and beauty industry is particularly vulnerable because of their distribution model and the propensity to sell higher-priced items. Considering that companies could be losing 5% of sales or more to gray marketers, it is no wonder that brand owners are now taking a hard look at their Brand Protection Strategies to combat this ever increasing problem.

Gray Market

More commonly known as “product diversion” or “parallel importing,” gray market activity can be considered a fraudulent means of inflating profits for participating distributors, while reducing brand owner revenue. Gray marketers capitalize on surplus inventory, lower manufacturing costs, fluctuating distribution costs, economic conditions, and currency exchange rates, by exporting goods without the permission of brand owners.

The gray marketers then undercut the prices of authorized domestic distributors by selling at lower price points, while achieving similar or higher profit margins due to the lower cost of product acquisition in the originating countries. Gray market product diversion can cycle through several brokers and resellers, who look for the lowest prices of products around the world.

The net effect of gray market is two-fold. First, the local distributors are forced to compete with artificially lowered prices by the gray market activity, causing significant conflict and supply chain demand issues within the authorized sales channels.

Second, product revenue streams for brand owners become unbalanced, causing inflated sales metrics in some regions, while incurring reduced revenues in other regions. In many cases, well-known retail stores may acquire gray market products through non-traditional channels, bypassing the brand owner's distribution network altogether.

Essentially, gray market activity disrupts the invisible hand of competition in a given sales region, by luring purchasers and consumers away from authorized channels, and creating artificial demand for goods imported by unauthorized means.

Brand Impact

Gray market product diversion is caused by geographic price disparities within various channel partners, from internal or external distributors, brokers, and resellers. As economic conditions change in various regions of the world on a daily basis, the currency exchange rates are affected. These global factors can be compounded by surplus inventories, as well as domestic rising or falling of manufacturing and distribution costs, creating the perfect storm for gray market diversion.

As a result, brand owners may experience channel conflict, inventory issues, wide price fluctuations, reduced margins, brand erosion, and brand equity concerns.

Gray market defined:

The unauthorized importing/exporting of genuine product from one region of the world, originally intended for sale in another region of the world—commonly referred to as “Product Diversion” or “Parallel Importing.”

Supply/demand and price impact

Enterprising channel partners and resellers take advantage of global conditions, knowing where they can obtain genuine product at the lowest price, and where they can sell it at the highest price. Without the proper monitoring of product price fluctuations throughout the world, gray market commerce can go undetected by manufacturers and brand owners.

Typically, authorized distributors in the localized sales regions will sense gray market activity, as they will see the effect of the artificially increased supply against the unchanged demand from consumers. The laws of economic forces drive prices down as supply goes up, causing authorized distributors to slow their order patterns from manufacturers and brand owners. This channel conflict creates inventory planning issues and demand problems within the authorized distribution system, which affects product pricing and availability concerns. It also can reduce the profit and revenue of brand owners impacted by the channel conflict.

Revenue and profit impact

Business relationships between manufacturers and their channel partners can also be negatively affected, particularly if the channel partner suspects the manufacturer is involved in the gray market commerce. In the end, authorized distributors may reduce their ordering from manufacturers, which lowers profits for both business entities.

In the case of B2B manufacturers, gray market activity can occur within their own walls, creating the illusion that certain sales regions are doing better than others when, in fact, the opposite may be true. When companies fail to respond to this internal problem, conflict can occur at the executive level, particularly when it affects bonuses and compensation plans.

Customer impact

From a customer buying perspective, consumers intuitively seek out lower prices over higher prices. However, consumers also balance product quality, safety, regulatory compliance, and warranty guarantees with advertised pricing, and they may pay more for genuine product over “suspect” product.

In the case of gray market sales, consumers are usually not informed that the product has been diverted through

Brand Impact

- Supply & Demand Imbalance
- Distributor Channel Conflict
- Disruptive Pricing Pressure
- Revenue Cannibalization
- Profit Erosion
- Negative Customer Experience
- Product Warranty & Safety Issues
- Legal & Regulatory Risk

unauthorized means, potentially creating issues with warranties and returns. In addition, certain options, accessories, functionality, and documentation intended for different regions may be missing from imported gray market products, creating customer dissatisfaction, brand equity issues, and safety concerns.

Some gray market resellers may change the packaging and instruction manuals to match languages in the affected regions. However, many of these products may have been designed for use in certain countries and, for safety reasons, should not be used in other countries—such as the case for certain electronics with required matching power supplies.

In addition, gray market diverters may remove packaging and instructions, as a means of disguising the origin of the product, depriving customers of potentially vital product information. Once the product is moved outside authorized distribution channels, quality control becomes non-existent, potentially exposing customers to expired or even tampered items, such as diluted fragrances and perfumes.



Product diversion creates artificially inflated profit margins for gray market distributors and insiders, while creating channel conflict and brand equity issues for the legitimate distributors and product manufacturers.

The legal issues

More recently, greater attention has been placed on the legality of gray market diversion throughout the world. Depending on the country, region, or union, and its individual laws and trade regulations, gray market diversion can be unlawful, if not banned altogether.

Some companies have addressed the problem through existing laws and trade controls. For example, a Japanese heavy machine manufacturer, with U.S. based operations, has pursued gray marketers through means of a General Exclusionary Order obtained from the International Trade Commission (ITC). This provides the brand owner legal recourse should gray marketers violate the ITC order. ITC orders can provide U.S. Customs officials authority to seize imported products in the United States.

In other cases, the U.S. Lanham Act has been used by U.S. trademark brand owners to defend against gray marketers, by arguing that the imported products are materially different from the U.S. versions, causing confusion within the marketplace and damage to the brand, leading to trademark infringement. Repackaging of products to disguise gray market methods may also be considered trademark infringement or even counterfeit product, depending on the circumstances.

In the European Union, trademark brand owners have looked to EU common law, which bans the importation of gray market products from non-EU countries. However, movement of gray market products within the EU is generally allowed.



Brand owners should:

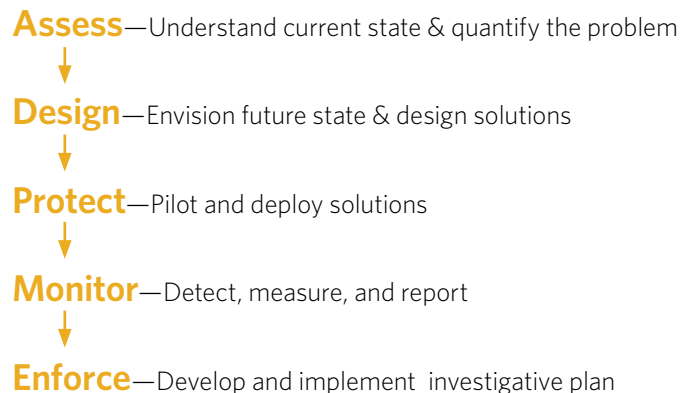
- Develop an end-to-end Brand Protection Strategy to defend against Gray Market Diversion
- Build industry knowledge by participating in Brand Protection Conferences and Industry Coalitions
- Consult with experts to assist in designing and implementing your Brand Protection Program

Brand Protection Methods

Brand owners should consider developing a Brand Protection Strategy and Architecture to defend against gray market diversion, as well as black market/counterfeit activity, and infringement of trademark, copyright, and intellectual property rights.

To maximize the probability of success, brand owners should consider collaborating with brand protection experts, such as **Kodak Solutions for Business**, who have broad experience in all types of brand protection problems. Brand protection experts will have a thorough understanding of the technology, capabilities, and cost of available solutions. In addition, they can evaluate possible solutions against best-practices.

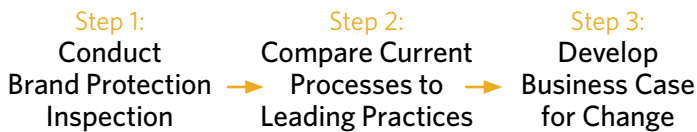
Kodak's approach to developing an end-to-end Brand Protection Strategy includes five steps:





Assess

In assessing a client’s brand protection problem, **Kodak Solutions for Business** consultants will inspect the processes and procedures in place, compare them to leading practices, and develop a business case for change.



In addition, Kodak will help customers understand gaps in their process, while developing a cost/benefit analysis for investments in Brand Protection Solutions. Potential analyses include:

- Product Pricing Analysis
- Supply Chain Analysis
- Marketplace Product Sampling/Covert Purchasing
- Product Inspection (Testing and Authentication)
- Distributor Identification (Authorized vs. Unauthorized)
- Cost Benefit Analysis for Brand Protection

Design

In the design stage, Kodak will lead the customer through a process which will outline a future state vision for a Brand Protection Strategy and Architecture. Potential areas to address include:

- Brand Protection Strategy Development
- Contingency Planning
- Risk Analysis Planning
- Global Price Harmonization Programs
- Brand Protection Training Programs
- Gray Market Awareness Campaigns

Protect

In the protect stage, Kodak will develop, test, and deploy solutions based on individual client requirements. Potential solutions include:

- Internet monitoring and detection systems for price and volume anomalies
- Overt security technologies that are easily verified through visual inspection
- Covert marking methods for product/packaging and associated detection devices
- Overt/covert serialization; track & trace systems
- Web-based and/or cell phone verification strategies

Monitor

In the monitor stage of brand protection, Kodak will assist clients in detecting, measuring, and reporting gray market issues. Potential activities include:

- Monitoring and Detection (Internet and marketplace)
- Channel/Product Sampling
- Manufacturing, Distribution, and Warehouse Inspections
- Product Import/Export Monitoring
- Reporting, Metrics, and Dashboard Development

Enforce

In the enforcement stage, Kodak will assist customers in understanding investigative methodologies, and guide them to the appropriate worldwide resources. Potential areas to address include:

- Development of Investigative Methodologies
- Investigative Consulting
- Customs Training Program Development
- Civil /Criminal Legal Referrals

Summary

Gray market product diversion is costing brand owners hundreds of billions of dollars worldwide. Through fraudulent methods, gray marketers prey on the inability of brand owners to detect product diversion through complex distribution channels around the globe.

Gray market diversion has a precipitous effect throughout the brand owners' distribution channels. Product diversion reduces brand owner profits, revenues, and market share, while eroding brand equity. In addition, gray market activity creates supply and demand imbalances, disrupts competitive pricing, and raises safety, warranty, and liability concerns.

In the end, manufacturers, distributors, and consumers are negatively impacted by gray market activity, making this an important issue to be addressed in any Brand Protection Strategy and Architecture.

Brand owners are encouraged to seek out industry knowledge and consulting expertise in order to address the difficult issues surrounding gray market product diversion.



**For more information about solutions
from Kodak:**

Visit www.kodak.com/go/brandprotection

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