



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

KPMG Gray Market Study Update

KPMG LLP



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Executive Summary

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.

Unsatisfied 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 up to 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. This means that 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 their products and enforce those guidelines.

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

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 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.

The gray market has many sources, i.e. 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. 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 to customers. 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 match or 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, 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.

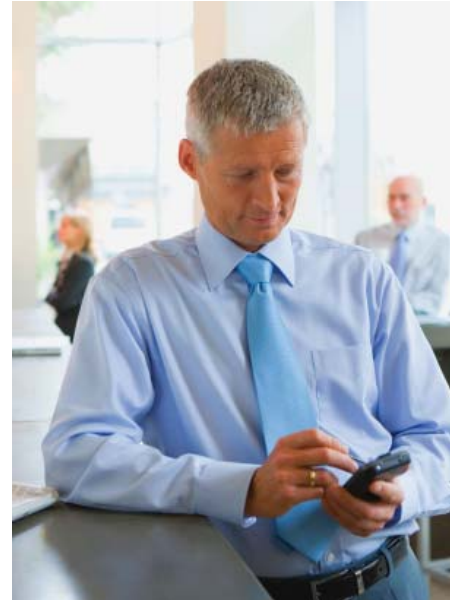
Objectives

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 (that could be exploited by channel partners either deliberately or accidentally). 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 as appropriate.
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 abuse, 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 point of sale (POS) and/or sent to support incentive claims. Ensure robust consequence management is supported and implemented by executive sales management.



Survey Findings

In 2002, KPMG conducted a survey focused on gray market issues in the information technology market. From September through October 2007, KPMG performed an expanded survey involving OEMs, channel partners, and brokers. The gray market was one focus of the new analysis. KPMG also looked deeper and broader into channel management and found not only a direct link between channel management effectiveness and gray market exposure, but found other losses associated with incentive programs that are not adequately processed and monitored.

The gray market has many sources. An OEM's decision to sell only through authorized channels and/or directly to select customers is designed to balance its cost of distribution with protection of its brand and product integrity in delivering the product to the end customer. The OEM expects its channel partners to make an investment in marketing, supporting, and servicing its products, and offers incentive programs, geographic territories, and price protection in exchange.

Whenever an unauthorized sourced product enters any geography, it competes with the authorized regional source by driving deeper discounting and posing a risk to brand reputation by having no obligation to provide any support or service. OEMs generally have no visibility into unauthorized sales and cannot ensure that products sold are new, authentic, undamaged goods and are properly installed and supported. The losers are end customers, channel partners, and OEMs.

Establishing effective processes to identify and monitor gray market diversion is a challenging task. We found that a majority of OEMs have a process to identify and monitor gray market impact, and the responsibility for implementing such processes was generally performed by sales and marketing groups as opposed to compliance functions. However, the effectiveness of such programs was identified as an issue by the survey. Furthermore, many OEMs have no formal training programs or internal employee code of conduct to address the internal drivers or enablers of gray market behavior. One result is that such OEMs perceive a muted problem because their "immune systems" are largely unaware.

When most OEMs encounter a gray market incident in the context of a warranty claim—usually as a result of a request for service by an end user or a complaint from an authorized channel partner—they may choose to honor the warranty and provide support to avoid brand reputation risk. To the customer, this may seem as if there is no difference between buying from an authorized or unauthorized channel and, therefore, is no disincentive to do so. This, combined with the initial lower cost of product, could actually result in an incentive for end customers to source from unauthorized brokers. It is not until they experience problems with gray market goods such as potentially increased failure rates, poor quality, product damage, etc., and seek support from the gray marketer (if they can get any) that they understand the full impact of their decision.

Reducing OEM Risks of Gray Market Behavior and Abuse of Incentive Programs

1. Review incentive programs to identify potential areas of weakness (that could be exploited by channel partners either deliberately or accidentally). As areas of weakness are uncovered, take steps to eliminate incentive program abuse.
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. Then act on those alerts as appropriate.
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 point of sale (POS) and/or sent to support incentive claims. Ensure robust consequence management is supported and implemented by executive sales management.

"It is a classic case of buyer beware!" says Lily Mei, executive director of AGMA.

Another area of potential OEM losses associated with gray marketing is incentive programs. OEMs use such incentives to spur sales, penetrate new markets, increase sales in developing markets, and promote brand loyalty among end users. However, there are no widely used systems or checks and balances for incentives claim reporting and processing. As a result, companies often end up paying incentives on sales that should not qualify under their incentive programs. The result is higher costs with no compensating payoff to the OEM, such as growth in sales or market share.

On the distribution side of the equation, channel partners are attracted to the gray market for several reasons including larger discounts, product availability, and often shorter lead times. Channel partners that were surveyed indicated it was often easier and quicker to buy product from the gray market than from their OEM, and for some OEMs, consequences were minimal for doing so. The balance is therefore tipped toward the path of least resistance.

"Most gray marketers claim the ability to deliver products to the customer faster than authorized channels or OEMs. Often they do not hesitate to commit to less than 48 hours delivery regardless of the size of the opportunity. In most instances, they approach their network of contacts and acquire as many products as they need wherever they can get it—all in that short period of time. No one should be surprised the products are often shipped to customers by different companies and that there is just no time to ensure what the products really are—new, used, refurbished, mislabeled, or counterfeit," says Ram Manchi, president of AGMA.

Ironically, many channel partners say their competitive positions are also threatened by gray market activities; however, these same channel partners are often enabling the practice. Apparently, the opportunity to make a quick sale, or obtain a product sooner and at lower cost, is not outweighed by stated or implied prohibitions. The key to changing channel partners' behavior will be in exacting consequences for participation in the gray market. When OEMs do not have adequate contractual provisions for their channel partners, do not monitor for compliance, and do not enforce contracts consistently, OEMs also perpetuate the problem.

Key Findings

The survey we conducted probed broadly and deeply into channel management from the perspectives of OEMs, channel partners, and brokers. What follows are the findings that have the most direct impact on gray market and incentive abuse activities. These findings are also the basis for the recommendations summarized in the preceding section and are described more fully in the summary section.

We conducted three different but similar surveys targeted at OEMs, channel partners, and brokers, respectively. Our key findings will therefore be qualified in similar terms. At the conclusion of the section, we combine findings from the multiple surveys to show a much broader view of the market.

OEMs

OEMs felt that the gray market has a broad impact on their businesses, in particular on profit and brand reputation. About half of those polled say that gray market products are often discounted more than 25 percent below the average authorized channel partners' price.

Many felt that the Internet "fuels" gray market activity and has the biggest influence on pricing, product availability, and movement of products across borders. Nearly 60 percent of OEMs surveyed stated they have implemented processes for identifying and monitoring gray market activity, 69 percent say these processes are managed partly by the sales group, while 61 percent place some of the responsibility under the marketing group. Only 39 percent, however, involve internal audit or finance, and only 43 percent involve corporate security.

More than three-quarters of OEM respondents say their internal employee code-of-conduct policies address appropriate behaviors regarding the gray market. Yet, 62 percent have no formal training programs to educate their own staff or customers about gray market issues. Half of the OEMs polled responded that they have no contractual provisions dealing with gray market activity in either their distribution or reseller agreements.

Those who do have such provisions usually include sanctions for sourcing from or selling to unauthorized companies. Many OEMs say they communicate gray market policy to authorized channels and customers via their Web-managed partner portals, external Web pages, and/or e-mail. Such practices lack a signed acknowledgement, which leaves the door open later to such statements as "I didn't know," "I did not get it," "I got it but did not read it," or "I did not understand it."

We strongly suggest that OEMs have contracts containing strong provisions coupled with regular communications reminding partners of their contractual obligations. The internal company's policies could also be an effective way to instill compliance.

AGMA's Treasurer Peter Hlavnicka suggests further steps can be taken to communicate a company's policies and provisions.

"Some AGMA members include specific compliance, gray market, and counterfeit training modules as part of the accreditation process for their new partners."

Not surprisingly, almost all OEMs (90 percent) offer incentives to their channel partners and customers. The most common are special pricing and promotional deals. Eighty-one percent of OEM respondents report they have some monitoring tools to manage and control global pricing; however, these are often manual Excel-based tools. Surprisingly, nearly one-third (31 percent) have no preferred system for reporting related to incentive claims. About a quarter (24 percent) of respondents use





POS reporting for the claims and of these, a fifth (20 percent) require this information via EDI feeds. The good news is that the majority of OEMs generally require some method of reporting.

Over a third of OEMs (38 percent) say they have experienced inappropriate incentive claims including sales to ineligible entities (67 percent), product procured from unauthorized sources (55 percent), and funds not being used for marketing as directed (52 percent). Almost half (48 percent) do not verify end users when processing relevant rebates. Those who do verify end users for each claim (52 percent) use product serial number tracking and/or require proof of purchase/invoice before processing any claim.

With regard to serial number tracking, 26 percent of OEM respondents sometimes require it, while 51 percent require channel partners to report serial numbers. Serial number tracking has other operational benefits, but tracking serial numbers is one of the most effective controls for preventing duplicate incentive claims, either on the same or under different programs, or claiming products from unauthorized sources. Those OEMs not using serial number tracking employ other controls to validate and track incentives.

AGMA's Vice President Marla Briscoe explains, "Tying incentive claims to serial numbers is key to insuring against incentive claim abuse. The uniqueness of each serial number for tracking, coupled with audit/monitoring and enforcement of program terms and conditions, provide an extra deterrent against abuse."

Channel Partners

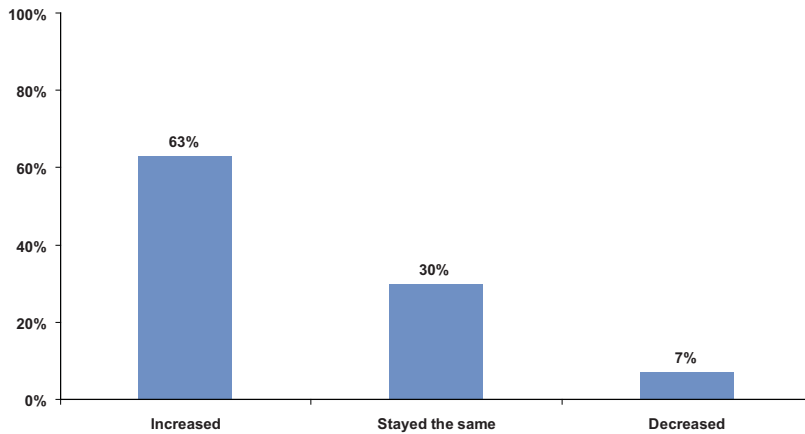
More than 38 percent of channel partner respondents admit to receiving offers from the gray market. Of those respondents who say they receive gray market offers, only 9 percent say they receive incentives from gray market sources. The incentive for them is the initial lower price and, in some cases, faster delivery. About 66 percent of respondents say they make gray market purchases but claim it amounts to less than 5 percent of their annual purchases, while nearly a quarter say their gray market purchases represent 11 to 30 percent of annual purchases. This activity creates demand and legitimacy for broker-supplied products. Therefore, participation in gray market activities contributes to the overall continuance of the problem.

Almost 4 in 10 channel partners say they receive gray market product offers, which most get via e-mail (94 percent). Interestingly, there are few password-protected Web sites that trade IT goods outside the authorized channel, like gray market channels for other products, there is no ability to ensure authenticity of these goods. Gray market products also find their way onto mainstream auction sites, and 59 percent of channel partner respondents say these Web sites present another opportunity to buy gray market goods.

Nearly half (47 percent) of the respondents said that the majority of solicitations still happen over the phone, which suggests the Internet's role appears to be an additional means of solicitation to create awareness of gray market availability rather than a more organized alternative to the pre-Internet ways of gray market peddling. Further, most transactions do not occur because of spam-like solicitations. Most respondents (60 percent) said the common scenario for purchasing gray market products is through a sales representative.

The most commonly purchased gray market products are hard-disk-drive storage products (48 percent of gray purchases). Consumer electronics and memory/

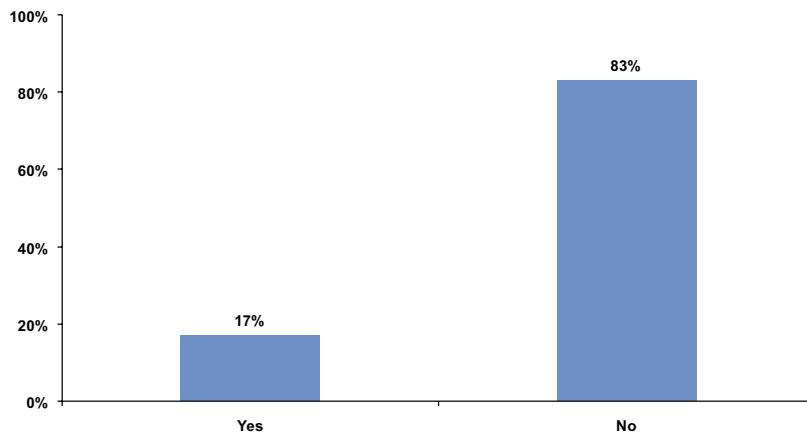
Over the last two years, the availability of gray market products has:



(Among channel partners that receive offers for gray market products)

“Putting things into perspective, when we talk about the IT industry, which had grown more than 81 percent since 2002, it should not be a surprise that gray market, in terms of dollar volume, grew as well. What is encouraging is that the gray market grew at a lower rate than the overall IT market. What is worrisome is that some of this growth is coming from goods that are misrepresented and sold as new but really are used, altered, or even counterfeit,” says Ram Manchi, AGMA’s president.

Have you received counterfeit products from gray market sources?



(Among channel partners that receive offers for gray market products)

integrated circuits (37 percent) account for the next highest proportion.

Brokers

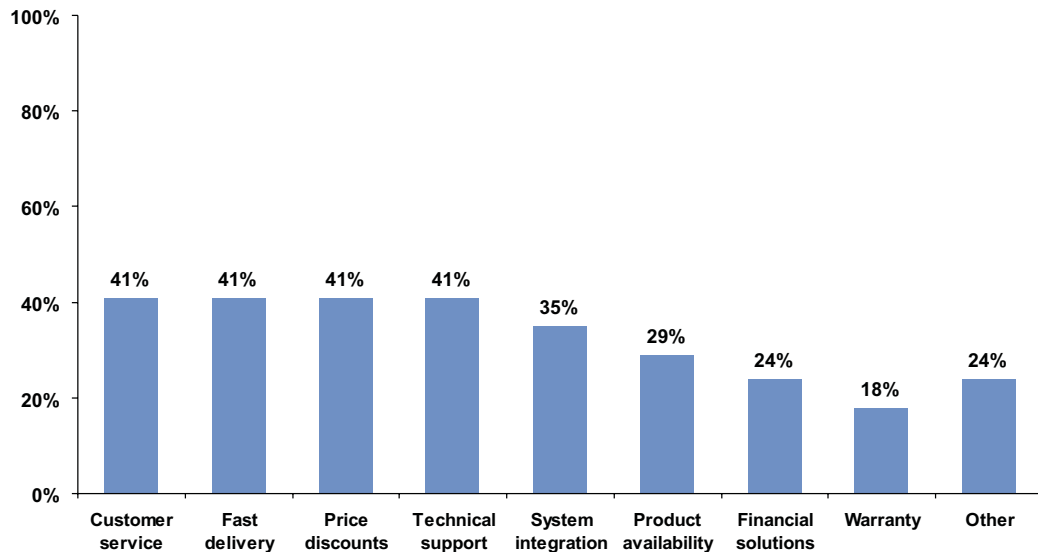
We believe broker activity and behavior patterns make up a key part of the gray market equation. For our broker survey, however, the number of respondents was simply too small to draw definitive conclusions. So, we include them for directional value only.

Many of the brokers who responded state that they promote products through sales representatives (53 percent). They also target corporate customers more than end-user individuals.

Brokers claim a host of value propositions, but no one broker purports to deliver them all. These include fast delivery, price discounts, customer service, technical support, and system integration. All brokers claimed that new (not used or refurbished) products account for the highest sales percentages of gray market product.

Only a few brokers stated they have been authorized as channel partners, and these do source products directly from OEMs. They also purchase from authorized channel partners and resellers around the globe. Stronger contractual policies and enforcement would probably discourage channel partners and resellers from selling outside their contractual bounds. Like channel partners, brokers lack good processes for verifying the authenticity or condition of products and/or identifying counterfeits. Often they do not even see or touch the products and serve as conduits through

Which of the following value propositions does your company provide to customers? (select all that apply)



Small base size. Findings are directional only.

which the gray market transactions flow.

Analysis

Based on our own experience in the field plus the data gleaned from this latest survey, we believe that each party in the product life cycle shares responsibility for contributing to the gray market challenge.

Customers who unwittingly or perhaps knowingly purchase from gray marketers should assess their buying practices and ensure they are purchasing from authorized sources. Channel partners can improve their buying and selling practices as OEM partners to better adhere to authorized programs and contracts and to drive more compliant behavior within their own organizations.

OEMs will probably continue to bear most of the burden to mitigate the flow of their products into the gray market. Current weaknesses in channel management almost encourage noncompliant behavior. Policies on paper, Web sites, and e-mails are proving insufficient to dissuade channel partners from taking advantage of a trusted relationship, despite the fact that most channel partners reportedly would also like to make the gray market evaporate. Their own fears could easily be on a list of why you should not stray from the authorized channel. They are already convinced; all that needs to be done is to work with them to toughen up the channel management.

In an earlier survey on POS reporting, we found that most channel partners were more than willing to go along with policies and submit to audits if they understood that better channel management was in everyone's best interest. They saw audits and rules as collaborative in ensuring a level playing field, rather than punitive.

If gray market discounts exceed 20 percent and go as high as 40 percent or more, it's hard to argue that authorized channel adherence is a benefit. However, when adding the other issues that channel partners see as risks, the argument is easier to make, and most channel partners are more than eager to work together with an OEM.

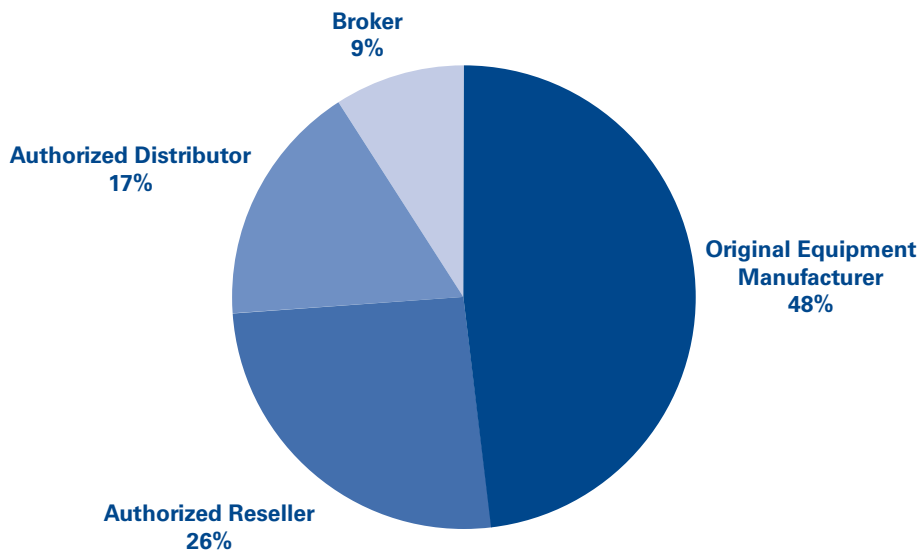
There are holes in authorized channels that can be and are being exploited. The first step is identifying those problem areas. The second is setting clear policies and sticking with them. Better monitoring and reporting is like radar on the highway: It makes everyone check their speedometers. Better processes for vetting channel partners and gauging promotions also closes some of those holes. Formal processes for tracking serial numbers throughout the channel and cooperative on-site auditing all help bolster channel management and reduce losses to gray markets and incentive abuse.



Survey Highlights

Three online surveys were conducted from September through October 2007. Based on answers to background questions, only respondents whose profiles matched the sampling criteria were counted.

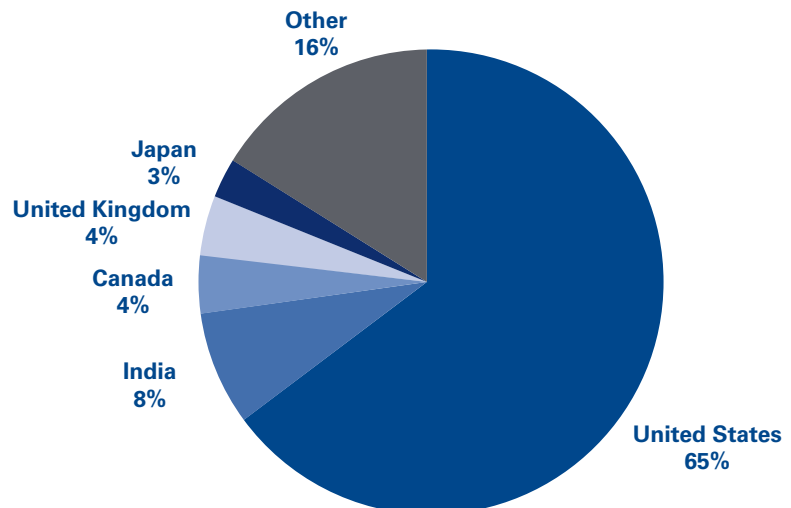
Respondents by Company Type



The survey included 90 OEMs, 82 channel partners, and 17 brokers. The sample sizes of the OEM and channel partner surveys produced results that are both representative and significant. The number of broker participants was too small to provide substantive findings and was treated as "directional."

Respondents by Geography

Based on the survey question regarding the location of the parent company, we found that 65 percent of respondents were from parent companies located in the United States.

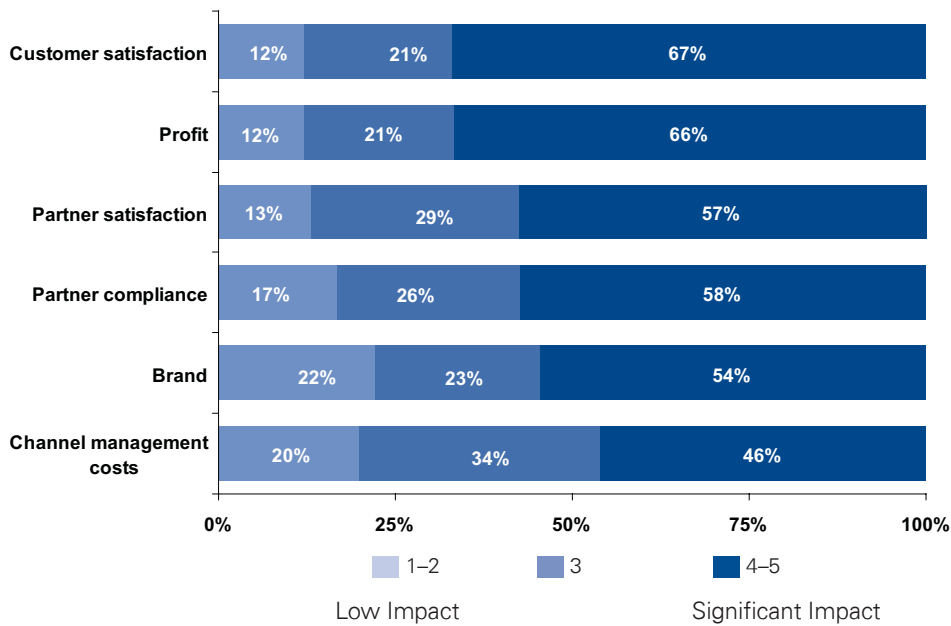


OEM Survey

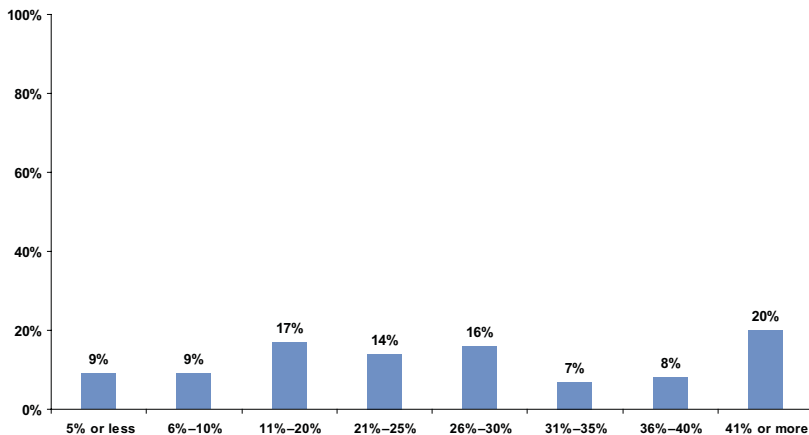
The total number of OEM respondents was 90. More than half of the respondents are divided between sales/marketing, vice president, and director titles. In addition, 75 percent of respondents are from companies with annual revenues of \$1 billion or more, and 38 percent are from companies with annual revenues over \$10 billion. This survey focused on the high-technology industry, including respondents from consumer electronics, storage, and computing, including components suppliers.

Gray Market Business Impact

Question: On a scale of 1 to 5, where 1 is “No Impact” and 5 is “Significant Impact”; rate how each of the following is impacted by the gray market.

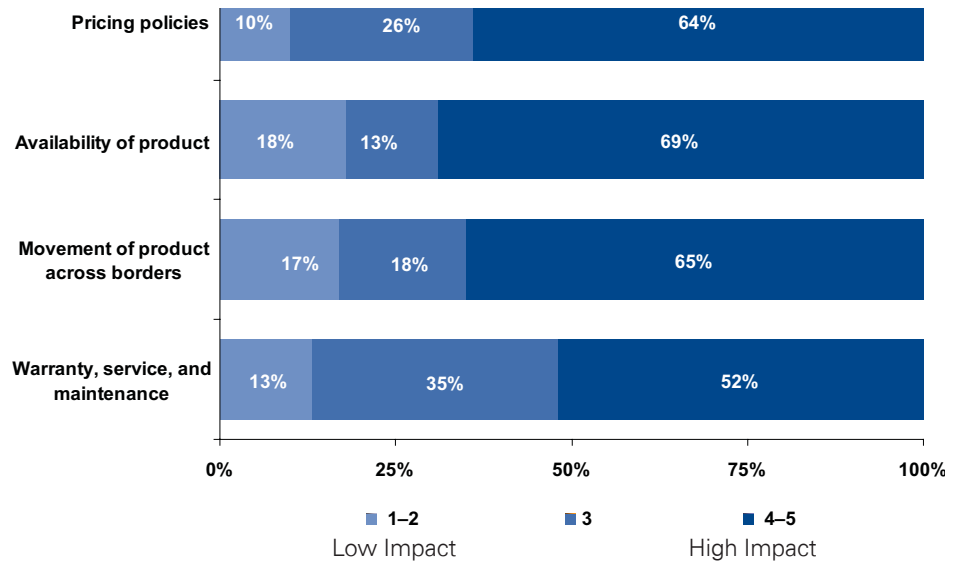


Question: When products are identified in the gray market, what is the average discount below list price?



Half of those polled say gray market products are discounted—on average—more than 25 percent below list price.

Question: On a scale of 1 to 5, where 1 is “No Impact” and 5 is “Significant Impact,” rate how the Internet has impacted the gray market for each of the following.



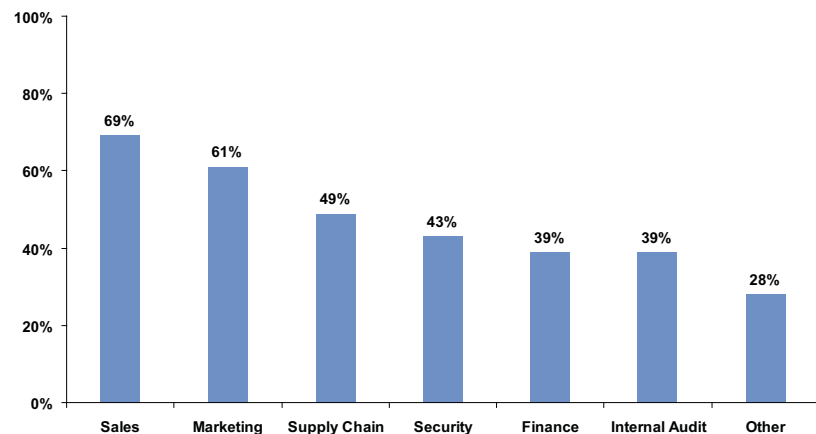
The above results indicate that the Internet has had most impact on availability of product. The Internet also had a significant impact on warranty, service, and maintenance.

Gray Market Defenses—Monitoring and Policies

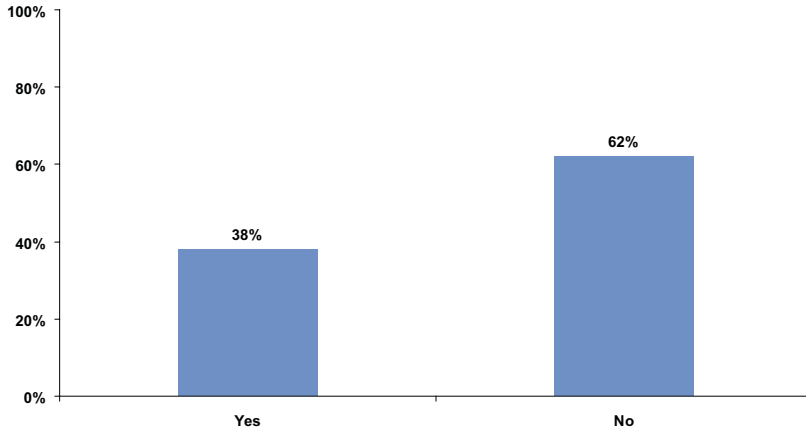
Question: Does your company have a process to identify or monitor gray market activity?

- Yes: 58 percent
- No: 42 percent

Question: If yes, which functions are involved in monitoring gray market activity?



Question: Does your company have any formal training program to educate staff/ customers about gray market concerns?



Question: Do you have provisions included in your reseller agreement addressing gray market activity?

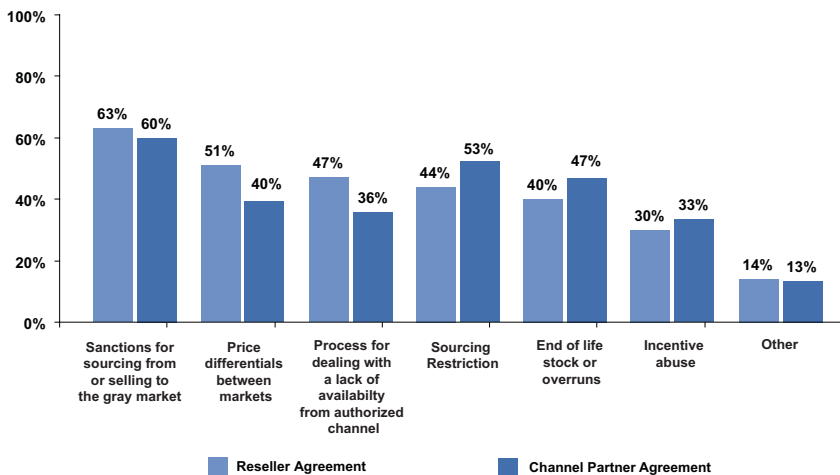
- Yes: 50 percent
- No: 50 percent

Question: Do you have provisions included in your channel partner agreement addressing gray market activity?

- Yes: 54 percent
- No: 46 percent

Response to Gray Market Activity

Question: Do you have provisions included in your channel partner agreement/ reseller agreement addressing gray market activity? If yes, which provisions are included? (Multiple responses allowed)

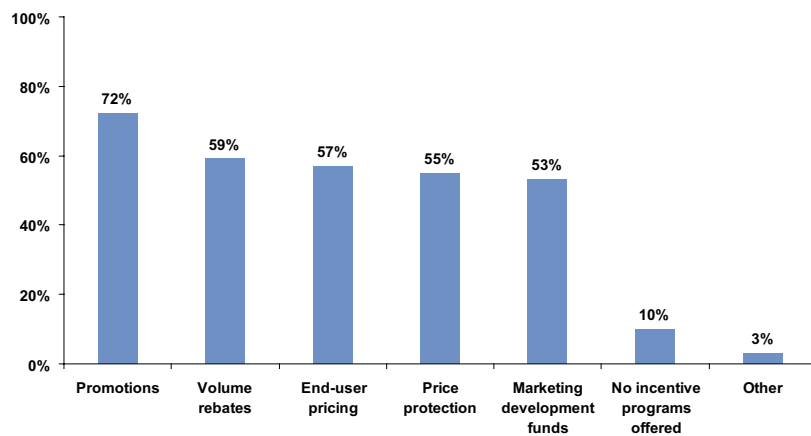


Question: Does your company support warranty and/or technical support on products sourced from the gray market?

- Yes: 12 percent
- Sometimes: 43 percent
- No: 45 percent

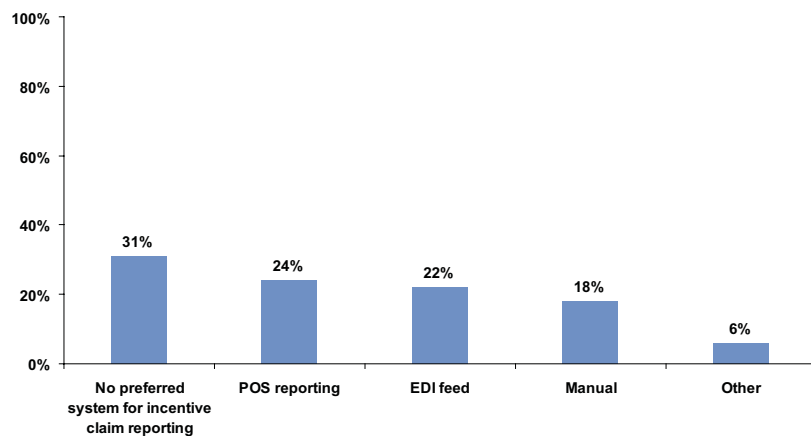
Incentives and Rebates

Question: What type of incentive programs do you offer? (Multiple responses allowed)



Nine in ten OEMs offer incentive programs.

Question: What is your company's preferred system for incentive claim reporting?*



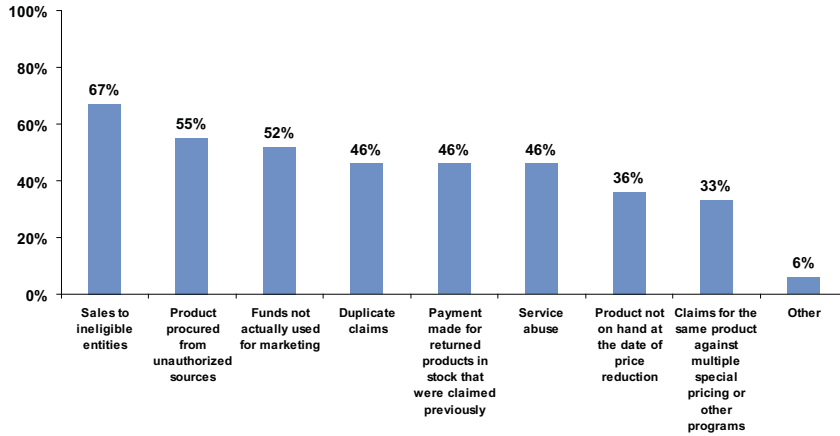
* Does not add up to 100 percent due to rounding.

Three in ten OEMs have no preferred system for incentive claim reporting.

Question: Have you identified situations where inappropriate claims have been made under your incentive programs?

- Yes: 38 percent
- No: 63 percent

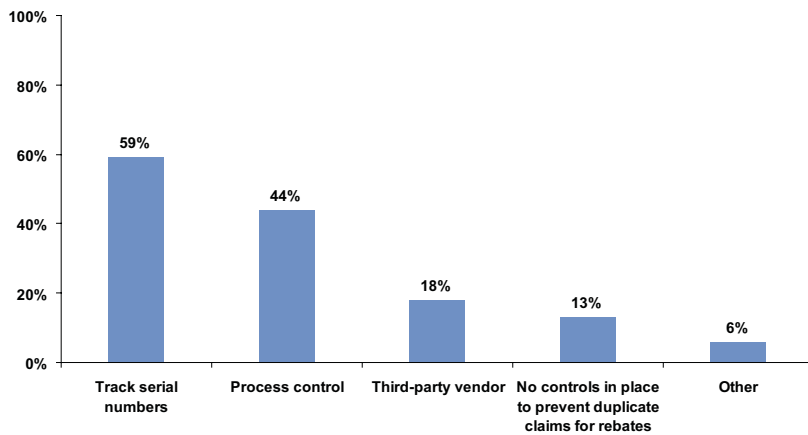
Of the 38 percent that answered yes, the types of inappropriate claims are listed below.



Question: Does your company verify end users for rebates?

- Yes: 52 percent
- No: 48 percent

Question: What controls does your company have in place to prevent duplicate claims for rebates?



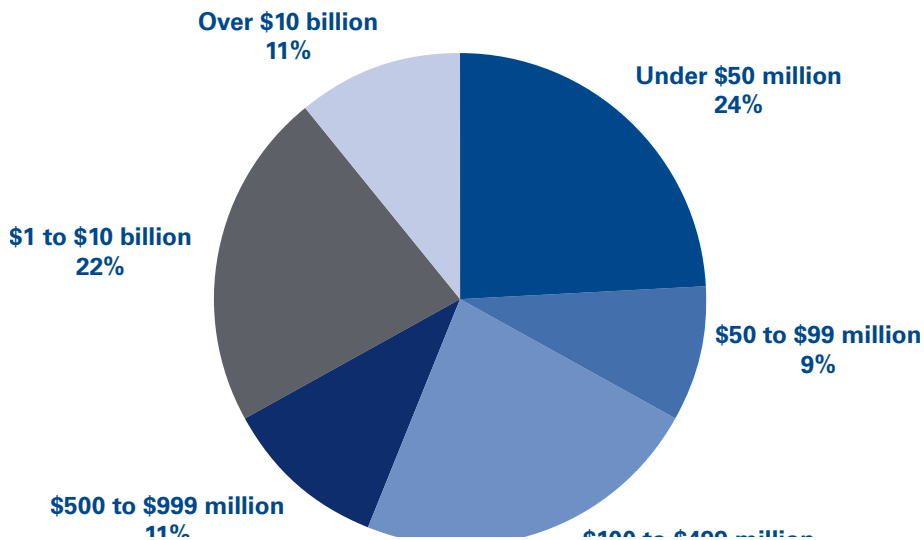
Question: Does your company require channel partners to track product serial numbers on sales to customers?

- Yes: 51 percent
- No: 24 percent
- Sometimes: 26 percent

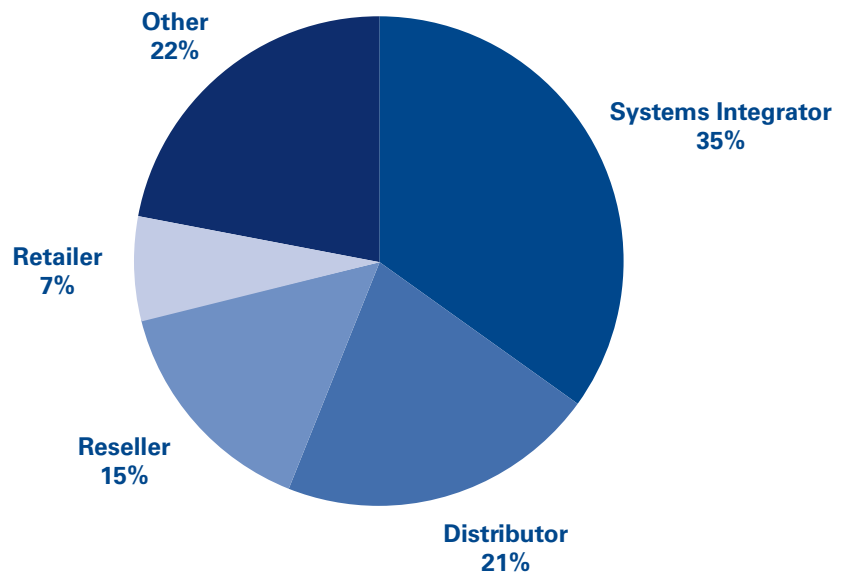
Channel Partner Survey

The total number of channel partner respondents was 82. About a quarter were from companies with under \$50 million in annual revenue, 23 percent were from companies with \$100 to \$499 million, 11 percent were from \$500 to \$999 million, and 22 percent represented companies of \$1 to \$10 billion dollars. Among those polled were system integrators (35 percent), first-tier channel partners (21 percent), second-tier resellers (15 percent), consumer retailers (7 percent), and others (22 percent). It is possible that resellers who classify themselves as "valued-added resellers," or VARs, may have selected "other" rather than "reseller" as a category, so it is reasonable to assume that some portion of that 22 percent in the "other" category may be resellers.

Respondents by Revenue Size



Respondents by Company Type

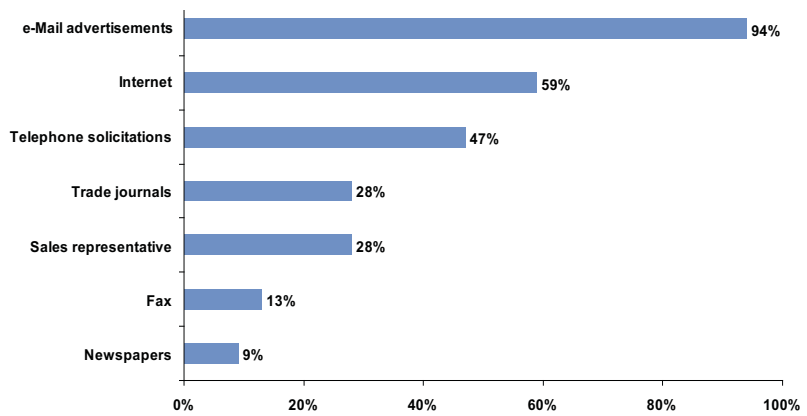


Gray Market Activities

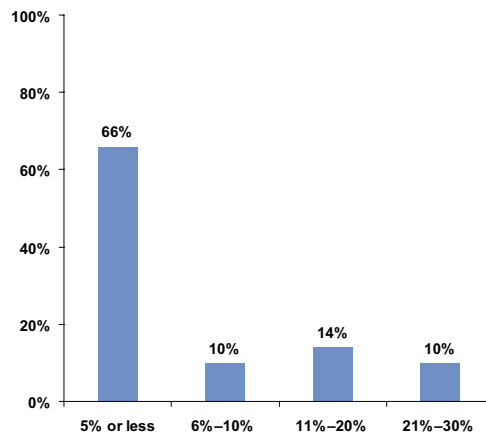
Question: Do you receive offers for gray market products?

- Yes: 38 percent
- No: 62 percent

Question: What are the most common methods utilized for receiving sales offers for gray market products and purchasing products from the gray market? (Among channel partners that receive offers for gray market products) (Multiple responses allowed)

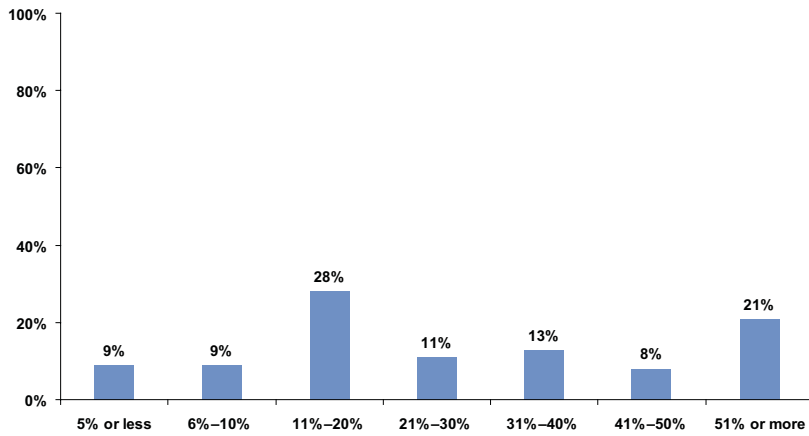


Question: What percentage of your total annual purchases is made from the gray market? (Among channel partners that receive offers for gray market products)



Two-thirds of channel partners say 5 percent or less annual purchases are made on the gray market.

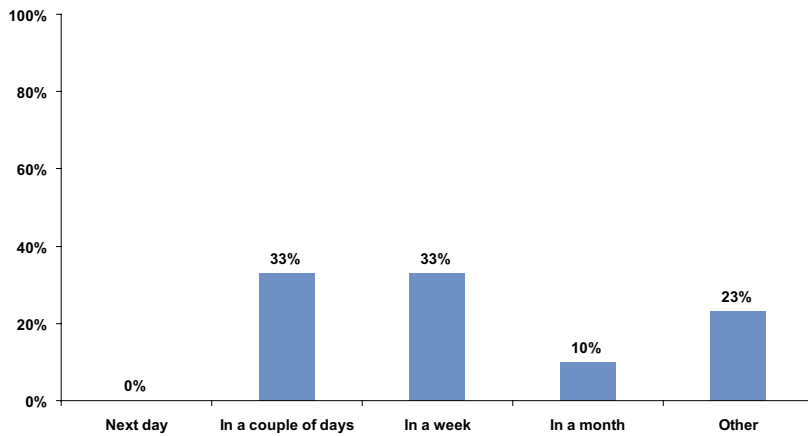
Question: Please indicate the purchase discount range. (Among channel partners that receive offers for gray market products)*



* Does not add up to 100 percent due to rounding.

The majority of channel partners say the purchase discount range of gray market products is more than 20 percent.

Question: On average, how quickly are products received when purchased from the gray market? (Among channel partners that receive offers for gray market products)*



* Does not add up to 100 percent due to rounding.

Two-thirds of channel partners say products purchased from gray market are received within a week.

Question: How does delivery time compare with authorized channel delivery?*(
Among channel partners that receive offers for gray market products)

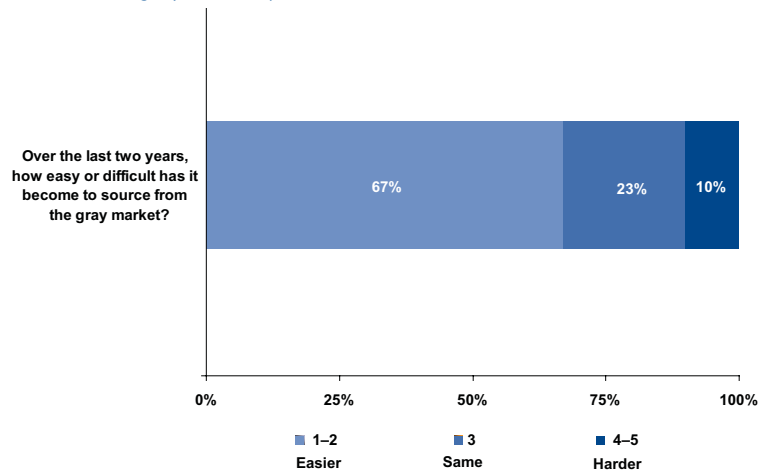
- Faster: 46 percent
- About the same: 46 percent
- Slower: 7 percent

* Does not add up to 100 percent due to rounding.

Question: Over the last two years, how has the availability of gray market products changed? (Among channel partners that receive offers for gray market products)

- Increased: 63 percent
- Stayed the same: 30 percent
- Decreased: 7 percent

Question: Over the last two years, how easy or difficult has it become to source from the gray market? (Among channel partners that receive offers for gray market products)



Question: Does your company report gray market sourced product in point-of-sale (POS) to the OEMs?

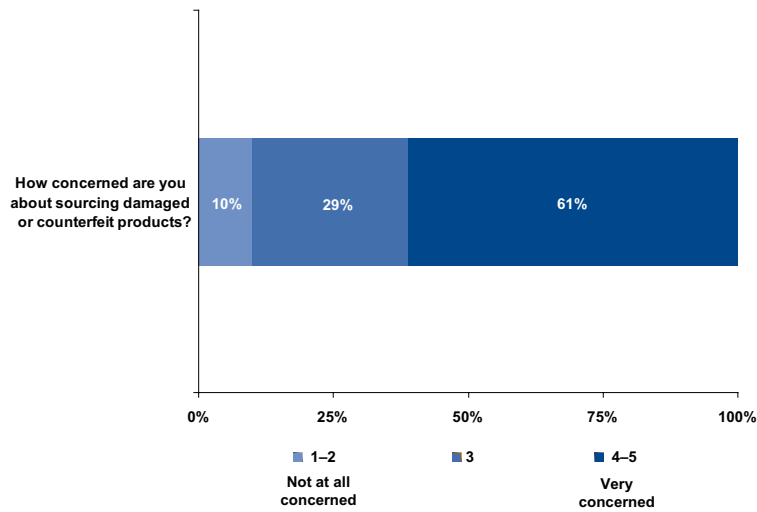
- Yes: 23 percent
- No: 77 percent

Question: How do you believe your company's competitive position would be affected if all gray market activities were eliminated? (Among channel partners that receive offers for gray market products)

- Would benefit: 51 percent
- No effect: 40 percent
- Would suffer: 9 percent

Gray Market Consequences

Question: When you purchase gray market products, how concerned are you about sourcing damaged or counterfeit products? (Among channel partners that receive offers for gray market products)



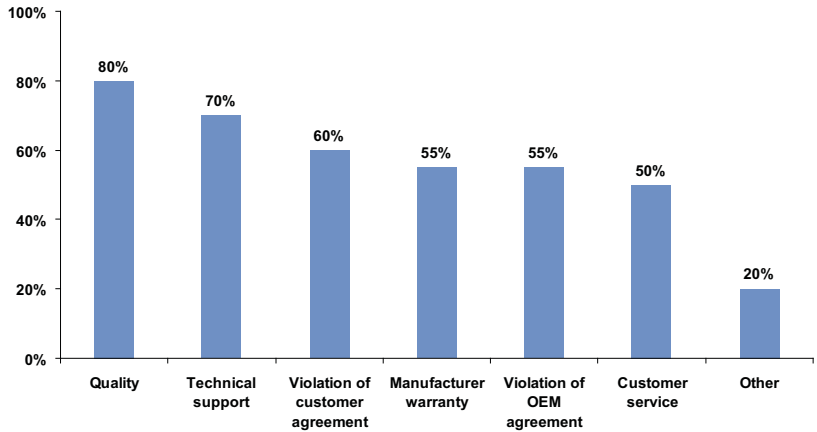
Question: Have you received counterfeit products from gray market sources? (Among channel partners that receive offers for gray market products)

- Yes: 17 percent
- No: 83 percent

Question: Do you have concerns about selling gray market products to your end customers? (Among channel partners that receive offers for gray market products)

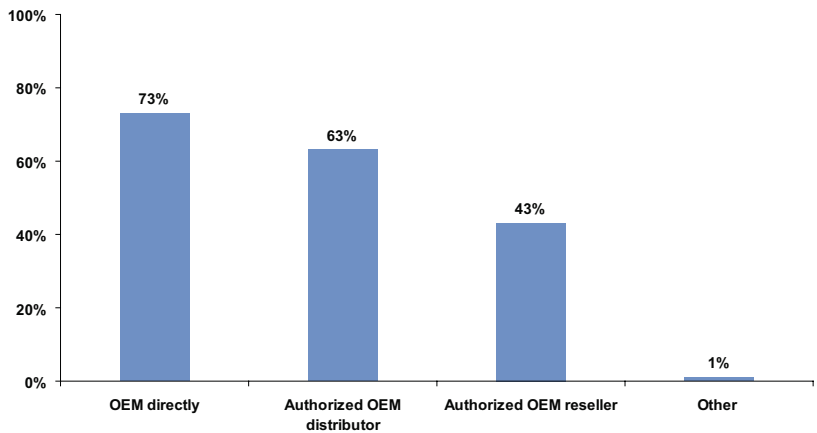
- Yes: 67 percent
- No: 33 percent

Question: What are your concerns? (Among channel partners that receive offers for gray market products and have concerns about selling gray market products to end customers) (Multiple responses allowed)



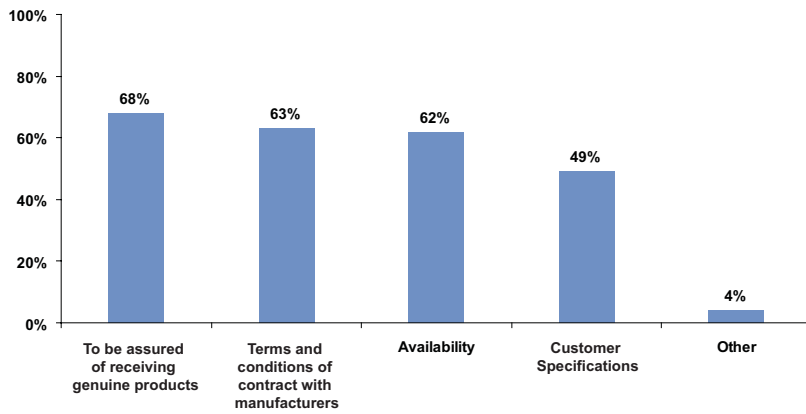
Where They Buy and Sell

Question: Where do you source new products from? (Multiple responses allowed)



Channel partners most commonly source new products directly from the OEM.

Question: If you source new products exclusively from authorized distribution channels, why? (Multiple responses allowed)



Question: Do your OEMs restrict or limit the products sold to your end customers?

- Yes: 39 percent
- No: 61 percent

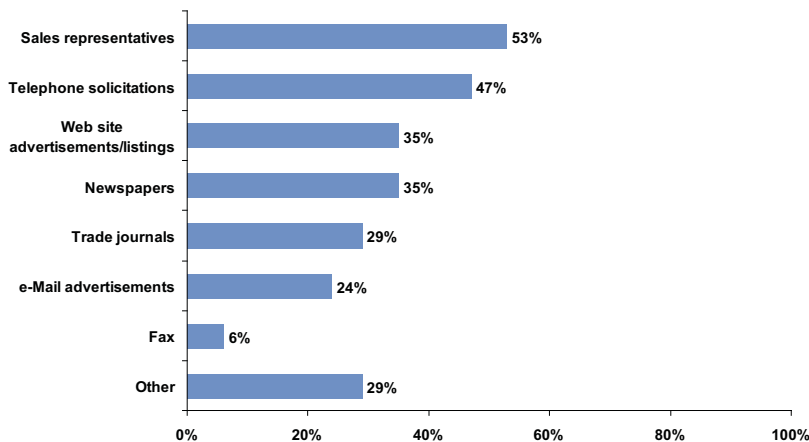
Question: Do you sell to nonauthorized end customers?

- Yes: 24 percent
- No: 76 percent

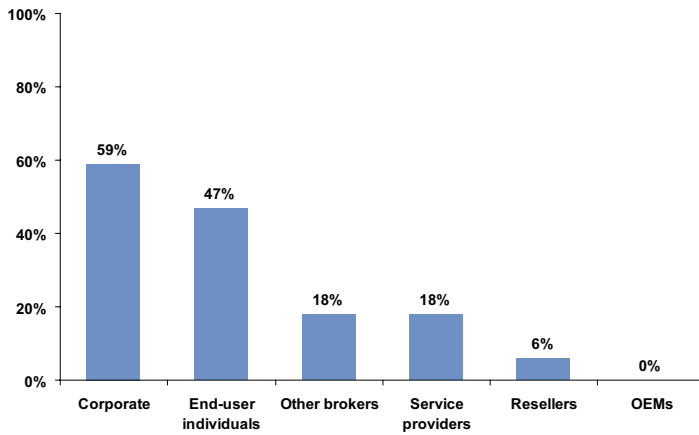
Broker Survey

As we stated earlier, the number of broker respondents was 17. This is too small a sample for definitive conclusions and is included only for "directional" consideration.

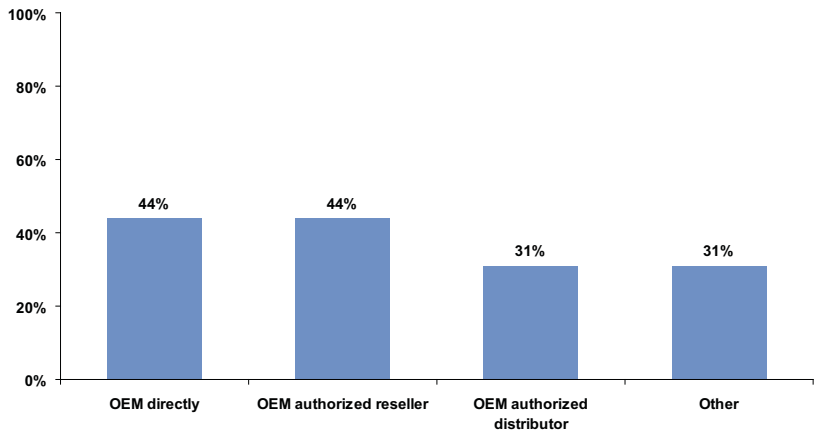
Question: How does your company promote its products to customers? (Multiple responses allowed.)



Question: Who are your company's targeted customers? (Multiple responses allowed)



Question: Where does your company source new OEM products? (Multiple responses allowed)



Question: Does your company provide warranty support services on products you sell? (Multiple responses allowed)

- Yes: 18 percent
- No: 82 percent



Impact of the Gray Market Calculation

This section of our study offers in tabular form the results of our findings and calculation methodology.

Revenue Impact

Revenue impact is calculated based on the revenue of the top 30 OEMs and factoring it by revenue not impacted by the gray market (service revenue) and by the number of respondents from our survey who only use authorized channels. As a result, the \$1.06 trillion total revenue is reduced to \$728 billion in 2007. This amount is still almost double the \$402 billion used from 2002 and is the result of the growth in technology spending over the past five years.

By factoring those revenue numbers by the percent of gray market purchases reflected in the 2002 and 2007 surveys, we found that the value of gray market product flowing in 2007 averaged \$58 billion (2002: \$20–\$40 billion). Gray market purchase data is derived from channel partner responses in both surveys (i.e., 2002 and 2007).

Value of Gray Market (GM) Product

Range	Revenue Potentially Subject to Gray Market (billions, USD)		Purchases from Gray Market (%)		Value of Gray Market Product (rounded to nearest billion, USD)	
	2007	2002	2007	2002	2007	2002
Low Range	\$728	\$402	5%	5%	\$36	\$20
Average Range	\$728	not available	8%	not available	\$58	not available
High Range	\$728	\$402	30%	10%	\$218	\$40

OEM Margin Impact

To calculate the gray market impact on margin, we start with the calculated value of the gray market product (\$58 billion on average) and factor it by the price advantage received from the gray market, which on average is 27 percent in 2007 and the price advantage not impacting end-user sale.¹ The resulting average impact on OEM margin is \$10 billion (2002: \$1–\$5 billion). The next calculation is the gray market revenue as a percentage of gross profit of the top 30 OEMs (which was \$275 billion). The result of this ratio is an average of 22 percent. The final calculation is the value of the gray market product as a percentage of total revenue, which on average is 7 percent. Note the results do not include gray market in software-only goods as software information gathered from the survey did not represent a statistically significant sample.

¹ We assumed, based on our survey results, that for 60 percent of the sales, the end users would have bought the products at the same price whether they went through the gray market or whether they went through a proper channel. In this case, any discounts that were originally paid to channel partners, brokers, etc., were absorbed by the channel and are true cost of gray market to the OEM.

For the other 40 percent where the end user receives a price advantage, we assumed that the end user would not have bought the product without this price advantage. Therefore, to make the sale, the OEM would have needed to provide the same discount either directly to the end user or via the channel. As a result, this profit is not lost to the gray market but to normal sales discounting.

OEM Margin Impact

Range	Value of Gray Market Product (billions, USD)		Price Advantage from Gray Market (% , weighted average)		Price Advantage Not Impacting End-User Sale		Impact on OEM Margin (billions, USD)		GM Revenue (as % of GP)	GM Revenue as % of Total Revenue	
	2007	2002	2007	2002	2007	2002	2007	2002	2007	2007	2002
Low Range	\$36	\$20	5%	10%	60%	60%	\$1.1	\$1.2	13.09%	4.00%	3.88%
Average Range	\$58	not available	27%	not available	60%	not available	\$10	not available	21.82%	6.67%	not available
High Range	\$218	\$40	51%	20%	60%	60%	\$67	\$5	79.27%	24.25%	7.77%

An Alternative Margin Impact (MarkMonitor®)

KPMG also built a model based on data received from MarkMonitor. The MarkMonitor data for price advantage is based on its observations from eCommerce sites and eBay. In other words, it provides an alternative view of price advantage to the one we captured from our OEM and channel partner survey.

To reiterate, our average price advantage percentage for purchasing from the gray market was 27 percent. The MarkMonitor percentage was 23 percent. The methodology to calculate the impact on margin mirrors the calculations above, but uses MarkMonitor data for the variable of the price advantage received by purchasing through the gray market. Using the MarkMonitor data, the impact on margin was on average \$8 billion compared to the \$10 billion calculated using the survey data.

OEM Margin Impact (MarkMonitor)

Range	Value of Gray Market Product (rounded to nearest billion, USD)	Price Advantage from Gray Market (% , weighted average)		Price Advantage Not Impacting End-User Sale		Impact on OEM Margin (billions, USD)	
	2007	2007	Mark	2007	Mark	2007	Mark
Low Range	\$36	5%	7%	60%	60%	\$1.1	\$1.5
Average Range	\$58	27%	23%	60%	60%	\$10	\$8
High Range	\$218	51%	37%	60%	60%	\$67	\$48

Segment Revenue and Impact²

The gray market does not affect all electronics industry segments equally and in the same manner. Some are more vulnerable to the impact of gray market transactions where others are more vulnerable to counterfeiting and/or large secondary market volumes. Products in some segments have much shorter life cycles than in others. For example, many businesses do not replace their networking or phone systems very often as updating is usually sufficient to increase the productivity. On the other hand, they have to replace their computers three or more times in the same period. Our segmental calculation broke the industry up into six segments: cell/PDA, computer (including servers and storage), consumer electronics, HDD – storage, memory and integrated circuits, and networking products.

Using the 80:20 rule (the assumption that 80 percent of the revenue is earned by the top 20 percent of companies in each segment), we studied the top five companies in each segment to estimate overall segment revenue. Based on segment data gathered during the survey, we applied the revenue and margin impact method outlined earlier using Mark Monitor segment data to calculate the profit impact.

Using the segment revenue as a starting point, we reduced the size of the market by 15 percent to factor out service revenue. We then reduced the market by another 19 percent to reflect the amount of product that will never flow through the gray market (to be consistent with the survey results). Subsequently, the adjusted market size was factored by 8 percent, the average amount of purchases from the gray market, the weighted average price variance calculated from the MarkMonitor segment data, and the 60 percent price advantage not impacting end-user sales.

Segment Revenue/Profit and Impact

Category	Market Revenue (billions, USD)	Adjusted Market Revenue (billions, USD)	Value of Gray Market Product flow (billions, USD)	Weighted Average Variance (Discount)	Price Advantage Not Impacting End-User Sales	Potential Gray Market Profit Impact (billions, USD)	GM Revenue (as % of GP)
Cell/PDA	\$159.36	\$109.72	\$8.78	30.21%	60%	\$1.59	2.91%
Computer, Servers, Storage	\$435.91	\$300.13	\$24.01	14.30%	60%	\$2.06	1.69%
Consumer Electronics	\$287.76	\$198.12	\$15.85	19.20%	60%	\$1.83	2.37%
HDD – Storage	\$33.30	\$22.93	\$1.83	7.19%	60%	\$0.08	1.10%
Memory – ICS	\$30.98	\$21.33	\$1.71	34.66%	60%	\$0.35	4.50%
Network Products	\$97.40	\$67.06	\$5.36	37.47%	60%	\$1.21	2.43%

² For Companies Used in Calculations

These calculations were based on data gleaned from 30 top OEMs, whose revenues ranged from \$104 million to about \$9 billion dollars. Collectively, their revenues totaled \$1.058 trillion. Gross profits were \$323 billion (\$275 billion when service profit is factored out).

Conclusion

OEMs create authorized channels to ensure channel integrity and expand their reach to end customers. Authorized channels help OEMs target deep discounts on their products by controlling the flow of product to the market through authorized channel partners and resellers while protecting end users with quality service and support. Channel partners and resellers are protected from a competitive free-for-all by meeting the OEM's service and support standards. The gray market disrupts this business model by creating an alternative unauthorized channel that rewards unauthorized resellers engaged in discount practices.

Not surprisingly, our survey found that most channel partners believe their market positions would benefit by eliminating gray markets, and most are concerned with the multiple issues that can arise when they stray outside the authorized channel. As a result, OEMs have a great opportunity to promote strong gray market mitigation programs and partner with the channel partners to drive out noncompliant behavior that is feeding the gray market problem.

OEMs do not have to create a perception change among their channel partners since these partners already believe it is better to stay within authorized limits, but these partners do require a push in the right direction through improved monitoring and enforcement efforts. As a result, there are three keys to stemming the unauthorized flow of goods into the gray market:

- Establishing a strong authorized channel by partnering with channel partners using contracts that set the boundaries for authorized selling
- Monitoring sales to ensure contract compliance
- Taking measures to enforce contracts through consistent consequences for noncompliance.

OEMs could start by establishing a clear corporate policy and providing their authorized channel partners with an unambiguous policy statement about the gray market and how management of incentive programs fit within that policy. The OEM sets the policy for who can buy and sell its products as well as the qualifications for receiving an incentive or rebate through authorized channels.

The effectiveness of those incentive programs depends largely on how well those policies about unauthorized reselling are communicated, monitored, and enforced. OEMs must establish an effective monitoring contract compliance program, which includes tracking how products move through the channel to end users; establish a channel partner review program; and ensure that only products and customers that are eligible receive incentives or rebates.

Finally, OEMs can achieve much more effective channel management by taking action when partners go astray. Contracts should have clear-cut terms and conditions that provide a roadmap for permissible reselling. If the terms and conditions of these contracts are broken, there should be consistent consequences for noncompliance. This kind of contract compliance monitoring can help drive compliance and result in a behavior change in the channel that is beneficial to OEMs, channel partners, and end customers alike.

Summary

Our study on the subject of gray market impact and channel management examines a few critical areas of focus that can put more teeth in tracking product flow and reducing unauthorized sales. With an average impact on profits of \$8 to \$10 billion in total, finding some processes and techniques that work will pay big dividends, which companies can see in their bottom line profits.

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 identify and 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
- Develop a channel partner review program to test the effectiveness of the policy
- Understand and take advantage of positive legal protections such as coding product for sale in Europe, etc.

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

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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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.

About MarkMonitor®

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