



THE GREY MARKET

Full Survey Report

A KPMG STUDY IN COOPERATION WITH THE ANTI-GRAY MARKET ALLIANCE

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CONTENTS

- I.** Executive Summary
- II.** What Is the Grey Market?
- III.** Impact on End Users, Distributors, and OEMs
- IV.** Practices to Deter Movement of Product into the Grey Market
- V.** Size and Scope of the Global Grey Market

I. EXECUTIVE SUMMARY



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.
- The majority of companies do not dedicate resources to manage grey market problems.

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

- 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.

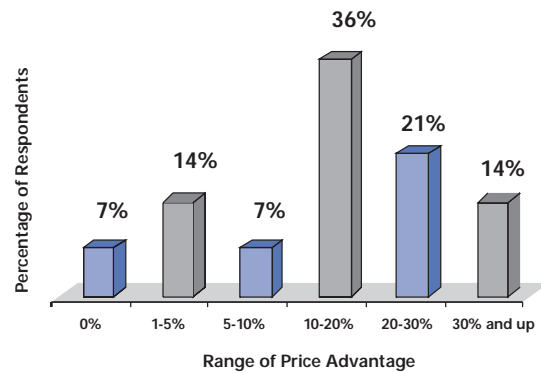
The bottom line: the grey market is hurting legitimate players in the computer manufacturing and distribution network, as well as customers and investors. The threat looms for OEMs and distributors as well as consumers who may think they are buying legitimate products. These unwitting customers may in 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.

RISKS AND REWARDS

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.

Range of price advantage obtained on grey market-sourced product

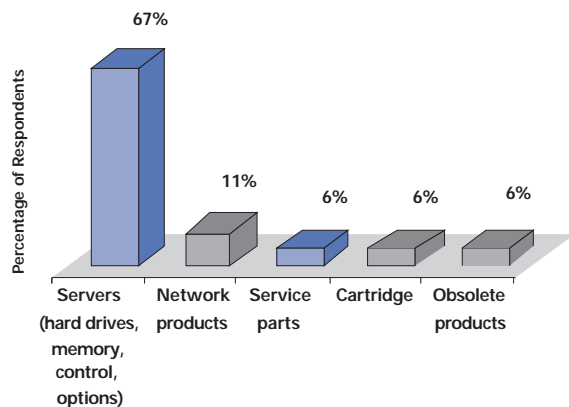


The players in both the authorized distribution channel and the grey market are inextricably woven together, and many have a foot in both camps. These two distribution channels strike a fine balance, providing each other with sources for needed products and a relief valve for bleeding off excess inventory. 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.

Products most often purchased from grey market sources



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

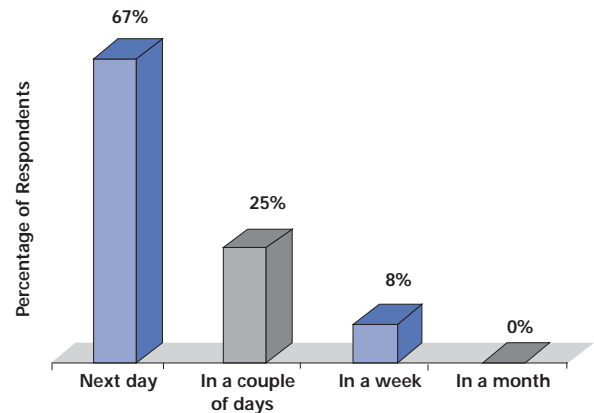
On one hand, the task of achieving status as a distributor is both costly and time consuming. Distributors must meet a variety of tests to obtain the seal of approval from the top brands in the business. On the other hand, the distributor typically sells products for hundreds of manufacturers and works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

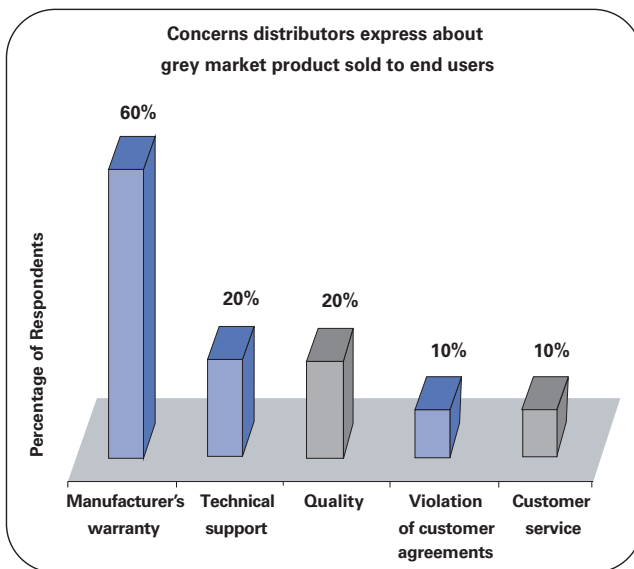
Distributors need to fully understand their contractual obligations and decide whether their corporation condones contractual and ethical violations to achieve profit. Strict adherence to these obligations would significantly reduce the demand for broker-supplied product.

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 noncompliant 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.

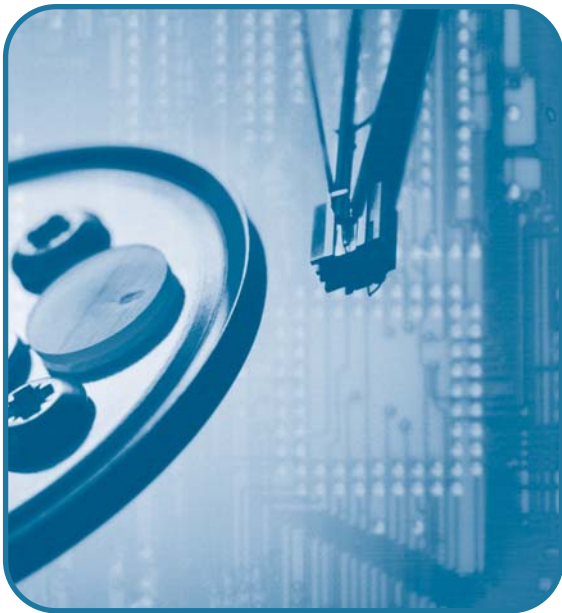
To learn more about the Anti–Gray Market Alliance, contact Marla Briscoe, Vice President, Anti–Gray Market Alliance, at 281–518–7818 or marla.briscoe@hp.com, or visit the Web site at www.antigraymarket.org.

II. WHAT IS THE GREY MARKET?



Grey market product is generally identified as genuine branded products that have slipped out of the normal distribution cycle and/or are imported into a market for sale without the consent or knowledge of the original

owner. Grey market products are generally sold at lower prices than those offered by authorized distribution partners. Authorized price differential to different markets and customers have created an opportunity for certain enterprises, such as a brokers, to purchase branded products at discounted rates then move them to locations where they can bring greater profits. As shown in the graph on page 53, distribution partners (including members of the distribution chain that are authorized to distribute OEM products) agree that there can be significant price advantages when product is purchased from the grey market rather than through authorized channels.



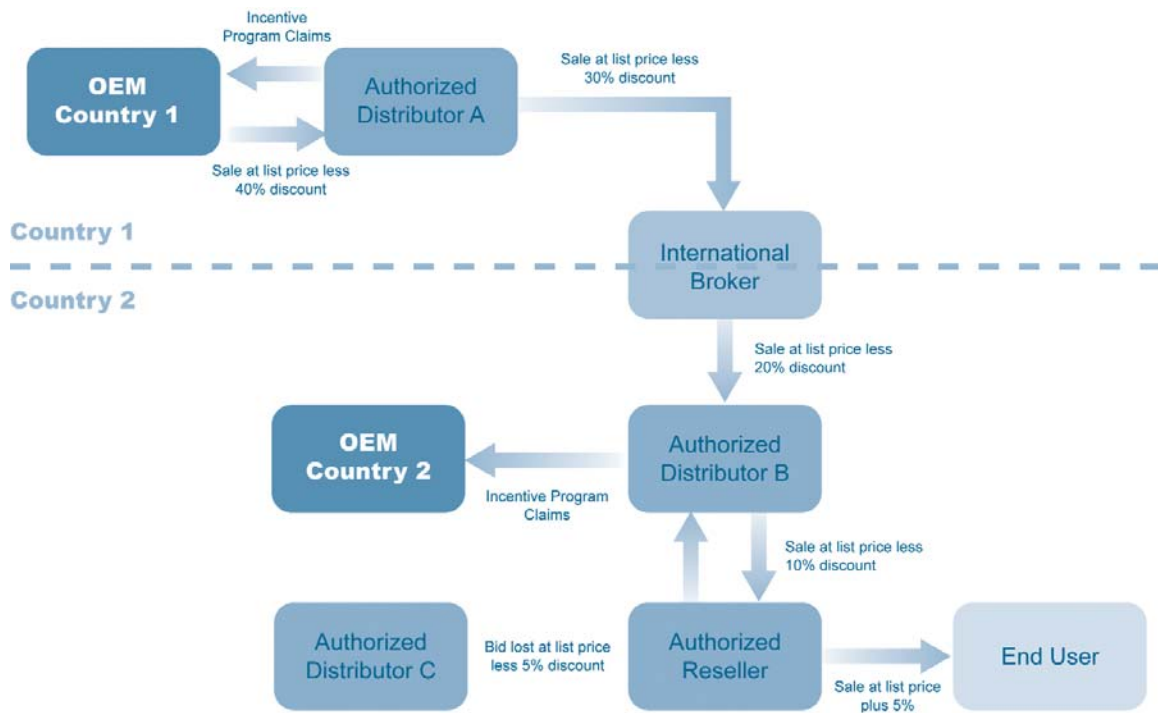
However, there are risks. By its very nature, the grey market is subterranean. Contract violations and product movement must be hidden from manufacturers. There may be deliberate deception to acquire goods from authorized sources, such as misrepresentation of end users in specific discount programs. The grey market environment is also often conspiratorial, wherein certain players form agreements to source and move product without manufacturers' knowledge.

Grey market goods are generally limited to popular, high-end, high-demand, high-margin branded products that are relatively easy to ship. Distribution partners surveyed have purchased hard drives, memory, and array controllers for servers, network products (Nic cards and switches), service parts, and printer cartridges through the grey market.

HOW DOES PRODUCT ENTER AND FLOW THROUGH THE GREY MARKET?

Product can enter the grey market through various channels. Grey market goods can come from OEMs themselves, through end-of-life stock, or overruns. More frequently, grey market goods can slip out of the normal distribution cycle when OEMs' distribution partners sell to brokers. In some cases OEMs are induced to provide discounts that drive grey market sales through fraudulent documentation or other forms of deception. Other times, discounts may be provided to increase the volume of product that a distributor is willing to purchase. In yet other cases, end users may purchase more product than they require and, instead of returning that product to the OEM, they may sell the leftover product to brokers.

The case below, derived from survey results, describes a typical example of how an authorized distributor diverted product that was discounted significantly by the OEM. Ultimately, the product moved to another country where an authorized distributor there lost the deal due to an inability to compete on price. This case identifies the roles various trading partners play in grey market transactions.



In the flow above the OEM, three different authorized entities (a broker, an authorized reseller, and end users) are part of the grey market flow of product. The diagram represents a common set of grey market transactions, but numerous variations exist.

OEM Country 1

The OEM started the flow of product by providing a 40 percent discount to the distributor. This discount may have been designed:

- ❑ *To be passed to a specific end user*
- ❑ *As a specific promotional program with defined terms to be met*
- ❑ *As a general discount to increase the volume of product that the distributor was willing to buy.*

The OEM may have ineffective controls over discount programs, which failed to ensure that product was shipped by the distributor to the intended end users, or that the terms of the promotion were followed. In KPMG's survey, 71 percent of OEMs performed some form of end user verification, however 71 percent of OEMs acknowledged that their end user verification process was not consistent globally. Sixty three percent of OEMs have identified situations where product did not reach the intended end users.

As 86 percent of the OEMs surveyed have received fraudulent documentation to support a rebate claim, it is possible that the distributor in this example may have created fraudulent documentation. Such documentation, if carefully prepared, can be extremely difficult for a control system to detect.

To meet sales targets, the OEM may encourage a distributor take more product than the distributor initially wanted by offering a significant discount. This discount may not be targeted to a specific end user, but may represent the necessary cost to induce the distributor to assume possession.

Authorized Distributor A

In the situations described above, the distributor obtains product at a significant discount. The distributor can choose to hold the product in inventory and sell it through its regular distribution model, keeping the 40 percent discount for itself, or it can move the product quickly, earning an instant profit of approximately 10 percent.

If the distributor has acquired a reasonable volume of product which can be easily sold in the normal business cycle it may wish to keep the product and earn a higher margin. In situations where the amount of product acquired is greater than the amount normally inventoried by the distributor, the distributor may choose to move the product quickly, before the product loses value over time, thus ensuring an attractive return on investment. In an industry where net income (as a percentage of revenue) is often less than 2 percent, an instant return of 10 percent can be difficult to for a distributor to resist.

The sale of the product to the broker would generally be a contravention of the OEM's contractual terms and conditions. In our survey, 86 percent of OEMs indicate that they prohibit selling product to unauthorized resellers.

International Broker

Grey market brokers exist to make a profit. Therefore, one of the broker's objectives is to sell above the net cost available to him, plus transportation. In the above example, the broker acquired product from an authorized distributor at a 30 percent discount and resold the product to an authorized distributor in another country, earning a 10 percent return. Margins in the range of 5 to 10 percent generally represent significant windfalls for grey market brokers, who have little overhead or cost infrastructure. Brokers tend to move inventory very quickly, often working with freight forwarders to avoid touching the inventory. As a broker is generally not covered by price protection, one of the biggest risks they face is a drop in price, which is common in the electronics industry. Brokers, as a result, are motivated to minimize inventory quantities.

Brokers tend to operate in a relatively subterranean manner. Distribution partners surveyed agree the majority of solicitations are through direct contact (81 percent via e-mail and 63 percent via telephone). Brokers use more public mediums less frequently. Only 38 percent of distribution partners claimed that brokers used Web sites to advertise and only 6 percent were aware of newspaper advertisements.

Of the brokers surveyed, only 10 percent were authorized by an OEM. Since brokers are not authorized, they do not make the investments required by an OEM of authorized distribution partners. This makes the grey market broker less cost intensive and more efficient than authorized distribution partners. The source of the product is often in countries where the grey market broker does not regularly operate and, as a result, may avoid specific legislative and contractual obligations, to which normal distribution partners are bound. Of the brokers surveyed, 70 percent indicated that they are able to acquire product from distribution partners, while 50 percent acquire

product directly from the OEM. Similarly, 70 percent claim that sourcing product has become easier over the past few years and 80 percent believe the slowdown in the IT industry has not negatively impacted their business.

Authorized Distributor B

Authorized Distributor B is offered product from a broker at a 20-percent discount compared to the price it would have to pay the local OEM. Although purchasing products from a broker probably contravenes its distribution contract with the OEM, the price advantage may be difficult to resist. Distributor B uses a portion of the price advantage it obtained to win business over Distributor C. In addition, Distributor B intentionally or unintentionally files rebate claims for product it obtained from the broker with the OEM in Country 2. Such claims are also probably in contravention of the terms of conditions of the OEM's rebate programs.

Authorized Reseller

The authorized reseller sources product from authorized Distributor B with little reason to suspect that this product is from the grey market. The reseller may question how Distributor B was able to provide a better price than Distributor C, but it may assume that Distributor B received some incentive payment from the OEM that Distributor C was not willing to pass to the reseller. The reseller has purchased product in compliance with its contract with the OEM.

End User

The end user has purchased product from an authorized reseller and has no reason to suspect that the product moved through the grey market. It may ultimately discover that the product was damaged, rebuilt to some extent with counterfeit product, or is delivered without a valid warranty.

At the end of the transaction, end users pay full price plus a 5 percent markup from an authorized reseller. End users, however, are unaware that the product they purchased went through the grey market. In addition, in Country 2 the OEM paid incentive program payments on the same products that had already received similar incentive payments in Country 1.

III. IMPACT ON END USERS, AUTHORIZED DISTRIBUTORS, AND OEMS



A

s noted above, end users are often unaware that product they've purchased has passed through the grey market. Frequently, end users pay the same price they would have paid for authorized product purchased from

an authorized reseller. In our survey, 60 percent of distribution partners said the grey market provided them with little or no price advantage. The remaining 40 percent claimed that a significant price advantage was passed on to the end user.



The survey noted that 79 percent of distribution partners were concerned about selling grey market product to end users and 56 percent expressed concern regarding the lack of valid OEM warranties. Other concerns included a lack of technical support, the quality of the product, and that the sale of such product could violate agreements with customers. In addition, 92 percent of distribution partners surveyed worried that grey market product is counterfeit. In fact, 50 percent of

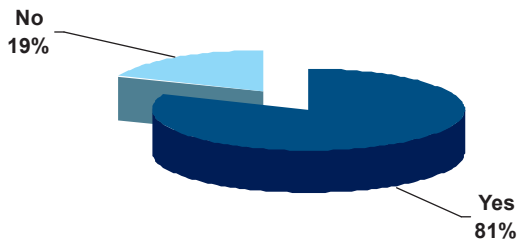
distribution partners surveyed said that at some point in the past they have received counterfeit product from the grey market. End users who receive grey market product bear the risk of receiving counterfeit or damaged product that may not be covered by warranty or adequate technical support.

In other cases, end users may receive genuine branded product with full warranties and technical support at a substantial price advantage. The grey market can provide advantages to end users, but these advantages are not without significant risk.

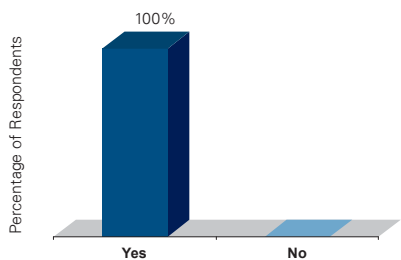
AUTHORIZED DISTRIBUTION PARTNERS

Of the distribution partners surveyed, 71 percent believe it is necessary to purchase product from the grey market. Over 41 percent purchase product from the grey market regularly. Fifty-five percent purchase between 5 and 10 percent of their total annual purchases from the grey market. Regarding the kinds of products distribution partners purchased from the grey market, 51 percent purchased server options, including hard drives, memory, and array controllers. Other products purchased from the grey market

Do you believe your competitive position would be enhanced if all grey market activities were eliminated?



Do you find that organizations that are not authorized to sell OEM product are able to offer OEM products to your end users at prices lower than yours?



include network products, service parts, printer cartridges, and obsolete or end-of-life products. When purchasing product from the grey market, 61 percent of distribution partners claimed a price advantage of at least 10 percent while 35 percent claimed a price advantage of 30 percent or more. Some 92 percent of distribution partners receive product from grey market sources within two days. Fifty-five percent of distribution partners said they receive product from the grey market faster than from OEM sources.

Distribution Partners comment that:

"The primary motivation for grey market activity is pricing."

"Price and availability are the main reasons to buy from the grey market."

Given the significant price advantage available from the grey market, distribution partners often claim that they

must purchase product from the grey market to remain competitive. In addition, as product is often available faster from the grey market, distribution partners may need to purchase grey market product to meet service-level commitments to end users.

Eighty-one percent of distribution partners surveyed believe their competitive position would be enhanced if all grey market activity were eliminated. Every distribution partner surveyed has, at some point, been forced to attempt to compete with unauthorized organizations that are able to offer lower prices. This is partly because brokers often do not have to incur the costs necessary to become authorized partners. If the grey market did not exist, authorized distribution partners would be able to compete fairly with other authorized distribution partners based on its efficiency of operations and their ability to add value for end users. Those who responded to the survey feel they would be better positioned to compete without the grey market.

“Give me a level playing field and let me out-execute my competition,” said one authorized distribution partner.

By purchasing grey market product, authorized distribution partners subject themselves to significant risks. Ninety-two percent of distribution partners surveyed are concerned about purchasing counterfeit product from the grey market and 50 percent have actually purchased counterfeit product. Seventy-nine percent were concerned about selling grey market product to end users. Fifty-six percent expressed concerns regarding the lack of valid OEM warranties.

Selling counterfeit product to a major end user could put in jeopardy the distribution partner's relationship—and opportunity for doing future business with that customer. In addition, the sale of such product could be a direct violation of a customer contract and may subject the distribution partner to litigation and/or financial penalties.

Additionally, the purchase of product from—and sale into—the grey market is a violation of contractual agreements between the distribution partners and the OEM. Contractual remedies can include penalties, litigation or loss of the ability to resell the OEM's products. Eighty-eight percent of OEMs surveyed have taken remedial action against distribution partners. Such action has included termination of contracts, formal warnings, and direct legal action.

OEMS

All of the OEMs surveyed acknowledge that they have been impacted by the grey market. Sixty-two percent have identified situations where product that was discounted for a specific end user was not ultimately delivered to the end user. Such product is often diverted into the grey market.

Eight-six percent of OEMs surveyed have identified situations where inappropriate claims were made under discount programs. Such inappropriate claims included:

- ▣ Duplicate claims (44%)
- ▣ Two distribution partners claimed a discount on the same serial number (29%)
- ▣ Abuse of incentive programs, including fraudulent documents (43%).

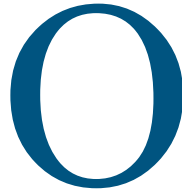
To be eligible for a discount under OEM's incentive programs, the product generally must be procured from an authorized source. Seventy percent of distribution partners surveyed claim that they do not include grey market-sourced product under OEM incentive programs. However, 53 percent of distribution partners did not have a system in place to identify whether a product was sourced from the grey market or from an authorized source. Therefore, at least 30 percent of distribution partners surveyed and likely higher (including those that don't have a system to prevent it) include grey market sourced product in OEM incentive programs in contravention of the terms and conditions of these programs. Frequently, grey market product has already received incentive monies from an OEM and the subsequent inclusion of the same product in incentive programs causes such incentive monies to be paid multiple times.

Of the distribution partners surveyed, 93 percent are concerned about sourcing damaged or counterfeit products through the grey market. Half of the distribution partners have experienced this problem. End users that receive grey market product are often

unaware of the source of the product, and any subsequent failure of the product will be attributed to an OEM doing a poor job of designing or manufacturing, thus threatening the relationship with the distribution partner. This can also decrease the value of the OEM's brand over time. In addition, since 67 percent of OEMs surveyed continue to provide warranties on grey market product, damaged or counterfeit materials may lead to higher warranty costs.

IV. PRACTICES TO DETER THE MOVEMENT OF PRODUCT INTO THE GREY MARKET





Our survey identified current practices used by OEMs to detect and deter the movement of product into the grey market. OEMs generally require that all distribution partners be authorized with a contractual agreement. Such agreements provide restrictions to limit grey market activity, including clauses that limit where and from whom product can be procured. Generally, product sales are limited as to the type of customer and the geography of the sale. Some OEMs have taken remedial action including de-authorization and litigation against distribution partners who have engaged in grey market activity.

OEM's use incentive claim systems to validate the appropriateness of claims. Specific procedures are undertaken to validate whether intended end users received the product. Some OEMs have developed tools to monitor global pricing, and most OEMs restrict pricing differential between countries to a relatively narrow range.

All OEMs have internal resources that address grey market issues. A small percentage of OEMs have a dedicated group. Some OEMs have training programs for grey market awareness and impose specific sanctions against grey market activities as part of their corporate codes of conduct.

Our survey identified the current practices outlined on the following pages:

AUTHORIZATION OF DISTRIBUTION PARTNERS

Following are some of the terms required by OEMs for authorization of distribution partners.

- 87 percent of OEMs authorize distribution partners
- Authorization process includes:
 - Credit authorization (83%)
 - Interviews of principals of potential distribution partner (67%)
 - Background check (50%)
 - Requirement that the partner meet significant minimum standards (100%)

DISTRIBUTION PARTNER AGREEMENTS

- Clauses to prevent or discourage grey market activity (78%)
- Requirement that product be procured from an authorized distribution source (86%)
- Requirement that product be procured and sold within an authorized territory (100%)
- Sanctions for sourcing or selling product from/to the Grey Market (75%)
- Requirement for distribution partners to track product serial numbers on sales out to the customers (50%)
- Audit rights (85%)

REMEDIAL ACTION TAKEN AGAINST DISTRIBUTION PARTNERS

- Remedial action taken against distribution partners for participating in the grey market (78%)
- Remedial actions include:
 - Termination of contract (100%)
 - Warning (50%)
 - Legal action (13%)

INCENTIVE CLAIM REPORTING

- Automated system used (86%)
- Incentive system populated electronically (75%)
- Incentive system populated by EDI feed from distribution partners (57%)
- Rebate submitted by:
 - Distributor (63%)
 - Reseller (63%)
 - End user (13%)
- Verification of end users (71%)
 - Verification process consistent globally (29%)
 - Requirement for end user documentation (83%)
 - Documentation includes:
 - Invoice from distribution partners to the end user (50%)
 - Shipping documentation (35%)
 - Serial number of product shipped (25%)

GLOBAL PRICING

- Monitoring tools to manage and control global pricing (22%)
- Percentage of price discrepancies allowed between countries:
 - 5–10 percent price discrepancies (50%)
 - 10–20 percent price discrepancies (50%)

INTERNAL GROUP RESPONSIBLE FOR GREY MARKET ISSUES

- Internal resources responsible for grey market issues (100%)
- Internal group fully dedicated to addressing grey market issues (33%)
- Internal resources are part of:
 - Sales and marketing (61%)
 - Security (13%)
 - Finance (13%)
 - Internal audit (13%)

AUDIT OF DISTRIBUTION PARTNERS

- Partner contract provides the right to conduct an audit of its distribution partners (85%)
- Partner contract provides specific financial penalties for non-compliance with contractual terms and conditions (25%) OEMs conducted audits of distribution partners (100%). Audits included review of:
 - Qualifications necessary to remain a partner (adequate trained personnel, appropriate amount of value added, etc.) (25%)
 - Grey market issues related to appropriate procurement and sale of product (50%)
 - Back-up documentation for incentive documentation was appropriate (50%) and Physical inventory (50%)
 - Audits conducted by an internal group and a third party (75%)
 - Audits conducted by their internal group only (25%).

Results of these audits include:

- Identified improvements in OEM internal control systems
- Provided recommendations for improvements in distribution partners' control systems to comply with contractual terms and condition
- Changes to contractual terms and conditions
- Identified recoveries of incentive payments made inappropriately to the distribution partner
- De-authorization of distribution partners.

FORMAL TRAINING PROGRAM TO EDUCATE EMPLOYEES ON GREY MARKET RISKS (22%)

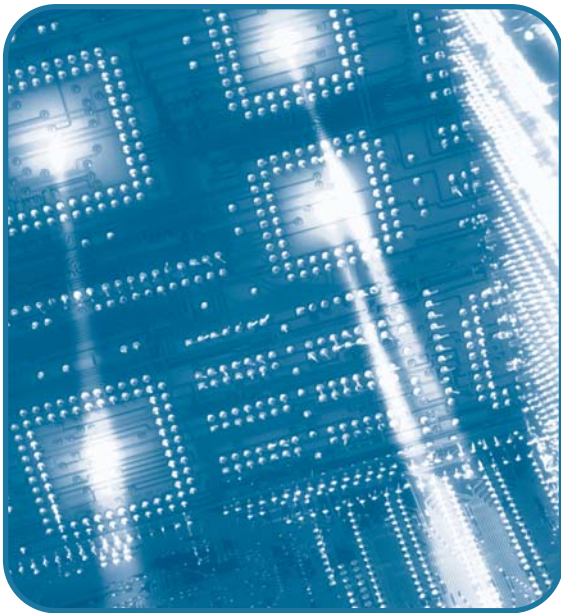
CORPORATE CODE OF CONDUCT ADDRESSES INAPPROPRIATE BEHAVIOR RELATED TO GREY MARKET (22%)

V. SIZE AND SCOPE OF THE GREY MARKET



D

ue to the pervasive nature of the grey market, multiple layers within OEMs' distribution systems, and a lack of consistent financial information, it is difficult to accurately estimate the extent of grey market activity and its impact on OEM margins. It is possible, however, to estimate a reasonable range of financial impact.



LOST MARGIN

Lost margin analyses in the computer sector often assume that, in the grey market, OEM unit sales are lost only occasionally and that reallocation of product among countries and geographical regions results in stable demand.

OEM unit volume is essentially a closed loop internationally, with the same number of units being sold through a grey market “multiple-tier” system, as would be sold through a normal two-tier distribution system. On occasion, customers may purchase product from a competitor, as a result of product availability and pricing, which might represent in an actual unit loss for OEMs. However, these instances are relatively uncommon. Consequently, if unit volume and sales remain constant under either scenario, the only significant impact is on margin, which is negatively affected.

In 60 percent of cases, the price paid by end users is competitive (comparable to the price they would have paid without the grey market). The primary difference is the margin that the OEM transfers into the channel to fund the additional layers of the marketplace that provide additional distribution tiers.

In a normal distribution environment, an OEM's product flows through a channel or distributor to a reseller, and then to the end user. In a grey market system, two or more additional tiers might be added to move product internationally or within a specific geography. Grey market brokers can only profitably achieve this if the OEM provides a discount at the first-tier level, in which case the OEM relinquishes margin that it might otherwise have used to fund additional tier layers in the marketplace.

Discounts offered by OEMs fall into three primary categories:

- ▣ *Normal margin transfer*, representing margin that would have been provided in the normal course to distribution partners in a two-tier distribution model.
- ▣ *Margin given away to the additional tiers over and above the normally expected distribution model*, and to which OEMs do not have immediate visibility. This represents profit earned by organizations that participate in grey market activity and is the primary area of loss to the OEM, according to survey results.
- ▣ *Program claims* that might be inappropriate, such as multiple claims under discount programs for the same units, or goal attainment and price protection claims based on broker-sourced product. (We have not attempted to quantify the impact of inappropriate program claims. Such claims would increase the impact on the OEM's margin.)

QUANTIFYING THE GREY MARKET

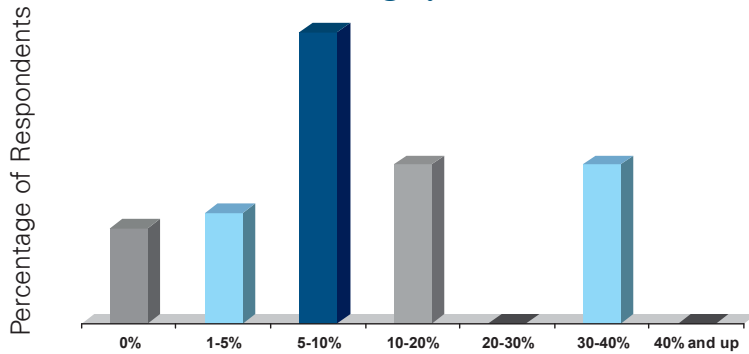
Product with Potential to Flow through the Grey Market

To quantify the size of the grey market we based our calculations on the impact it has made on the top 30 OEMs in the 2001 “Electronic Business 300” (as listed in the January 2002 issue of *Electronic Business* magazine). The sale of OEM products, as noted previously, is essentially a closed loop. Therefore, OEM product sales made through distribution channels are equal to distribution partners' purchases of OEM product. For the OEMs impacted we totaled product revenue as reported in their most recent annual reports. We used publicly available information and estimates as necessary to determine the portion of product revenue that went through the distribution channel as opposed to direct sales. As a result of the assumptions and calculations above, we estimate that total annual indirect product revenue from our group of major electronic manufactures is \$515 billion.

Distribution Partner Purchases

As the OEM unit volume is essentially a closed loop, we assume that distribution partner purchases of OEM product equal \$515 billion. Our survey shows that 18 percent of distribution partners did not purchase any product from the grey market. Therefore, we reduced the amount of product with the potential to flow through the grey market to \$402 billion—82 percent of \$515 billion.

What percentage of total annual purchases are made from the grey market?



Percentage of Total Distribution Partner Purchases from the Grey Market

The vast majority of distribution partners surveyed said between 5 and 10 percent of their purchases came from the grey market. For calculation purposes we used 5 percent as the lower range and 10 percent as the higher range:

	Total Purchases (billions)	Percentage of Purchases from the Gray Market	Purchases from the Gray Market (billions)	Rounded (billions)
Lower Range	USD \$402	5%	USD \$20.1	USD \$20
Higher Range	USD \$402	10%	USD \$40.2	USD \$40

Margin Lost to the Grey Market

Profit margin lost to the grey market represents money given away to other tiers that would not otherwise have been necessary to sell the product to the end user.

Distribution partners surveyed responded that they obtain the following price advantage when purchasing product from the grey market:

Based on the information above we assume a low–end price advantage of 10 percent and a high–end advantage of 20 percent. These numbers are conservative since they only represent profit earned by distribution partners and do not take into account the margins also earned by brokers or other distribution partners who may have handled the product. Distribution partners also said that 60 percent of the time end user price is not significantly impacted by grey market activity. To be conservative, we assume that OEMs would have to offer an additional discount in order to secure the remaining 40 percent of sales in which end users did receive a discount from grey market activity.

	Product Purchased from the Gray Market (Billions)	Price Advantage from the Gray Market	Price Advantage not necessary for the end user sale	Impact on OEM Margin (Billions)
Lower Range	USD \$20.1	10%	60%	USD \$1.2
Higher Range	USD \$40.2	20%	60%	USD \$4.8

As a result, it is estimated that USD \$20–40 billion of computer electronic product passes through the grey market per year resulting in a loss of margin to OEMs of between USD \$1.2 to USD \$4.8 billion per year.

Our calculations were based on conservative figures. The impact on margin would actually be increased if calculations included margin lost to multiple layers within the grey market, rather than considering only the final layer, as was done in these calculations. In addition, the margin impact would be increased if an amount were included for inappropriate program claims made by distribution partners on product sourced from the grey market.

KPMG's provides information access, measurement, and compliance services specifically for managing a company's investment in its distribution channel programs and partnerships.

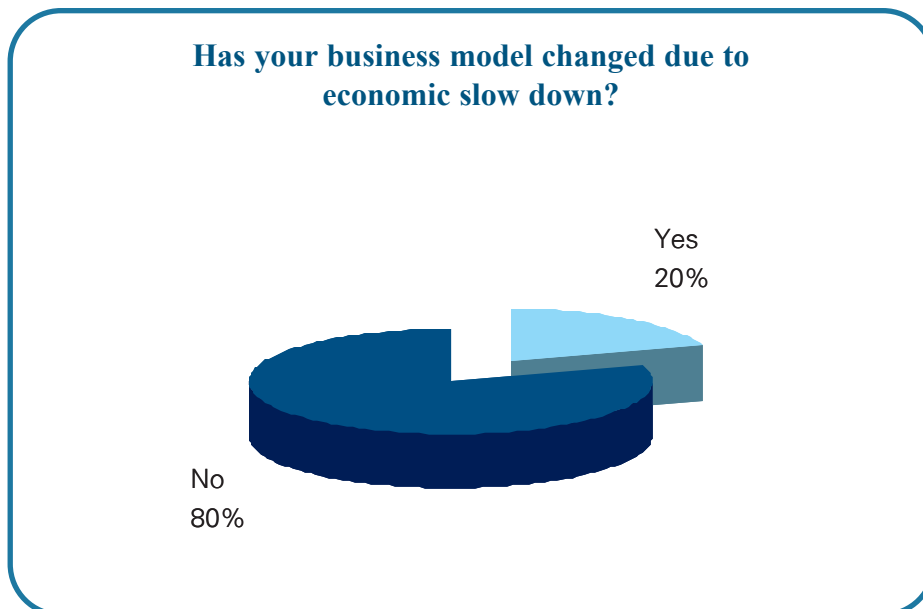
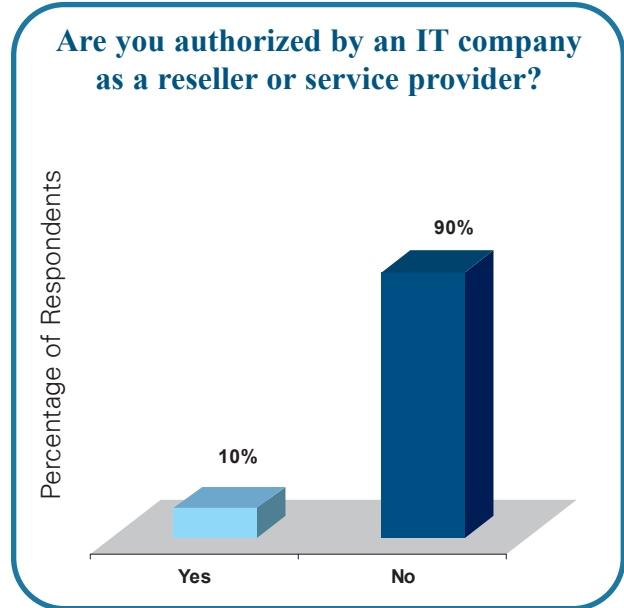
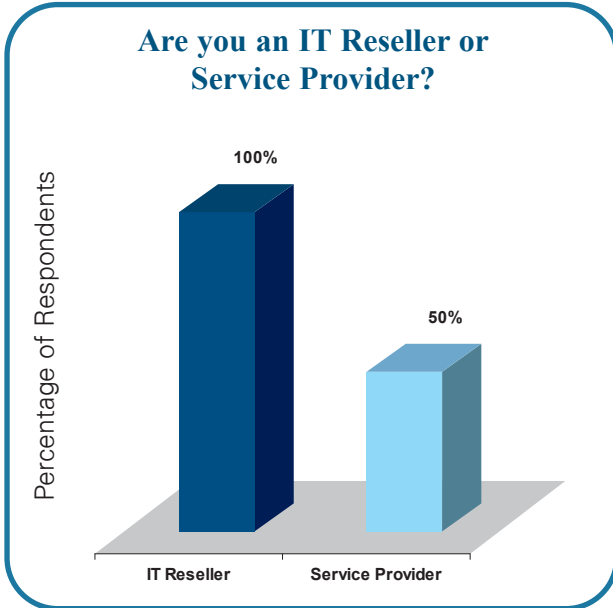
We can help OEMs improve their resistance to grey market maladies and recover losses from noncompliant distributors through a suite of services including:

- ▣ 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

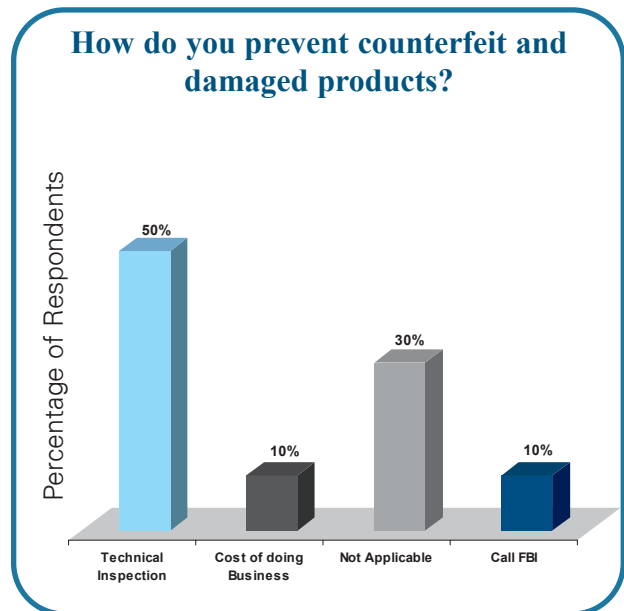
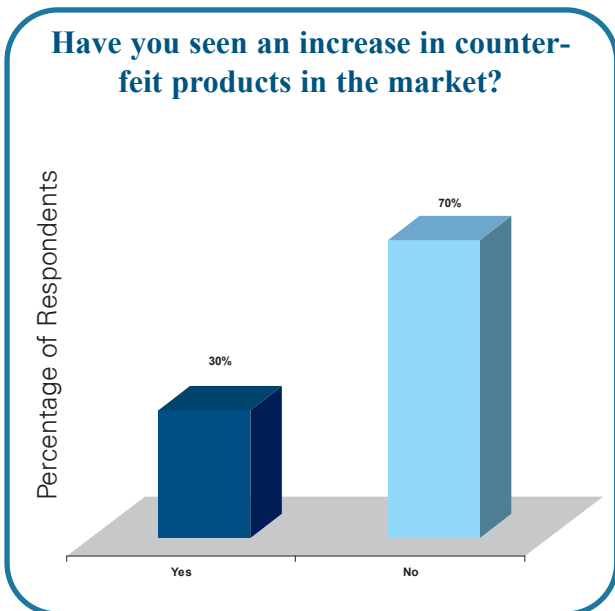
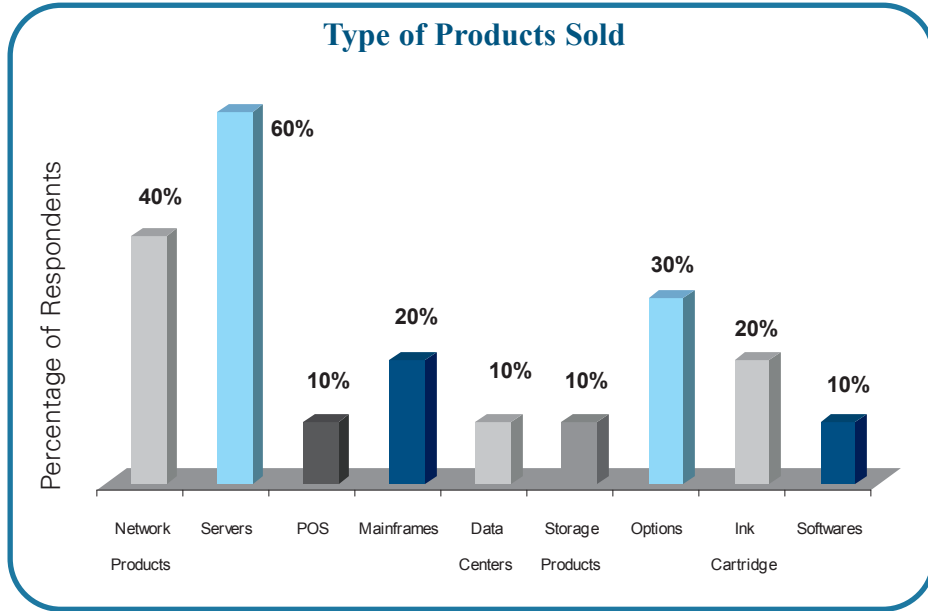
APPENDICES



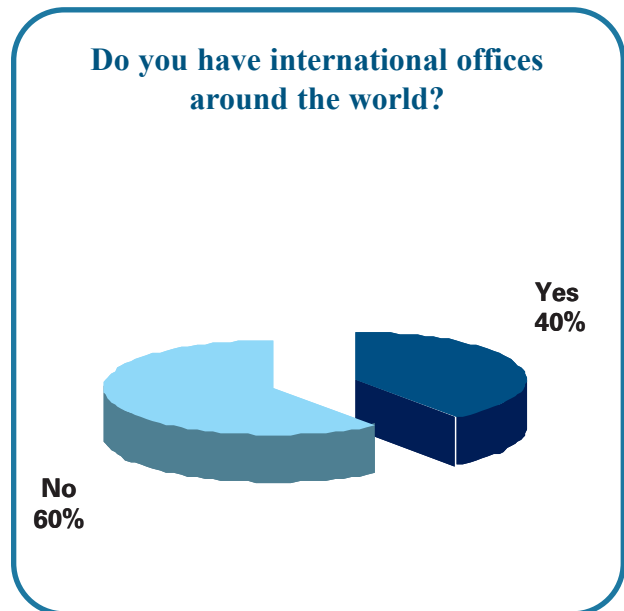
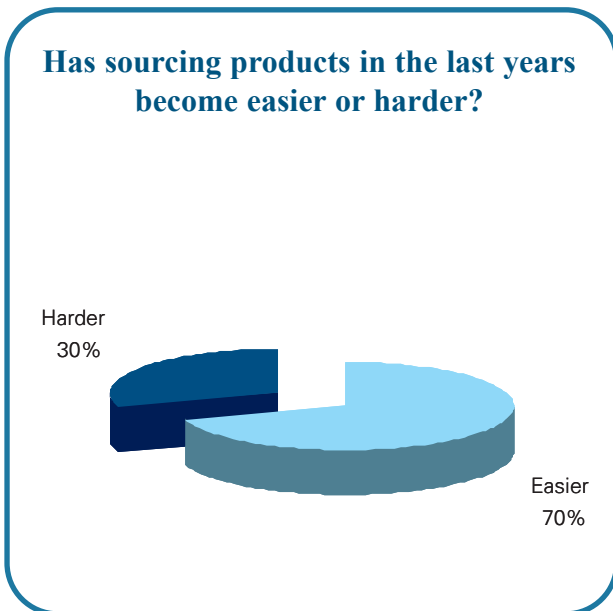
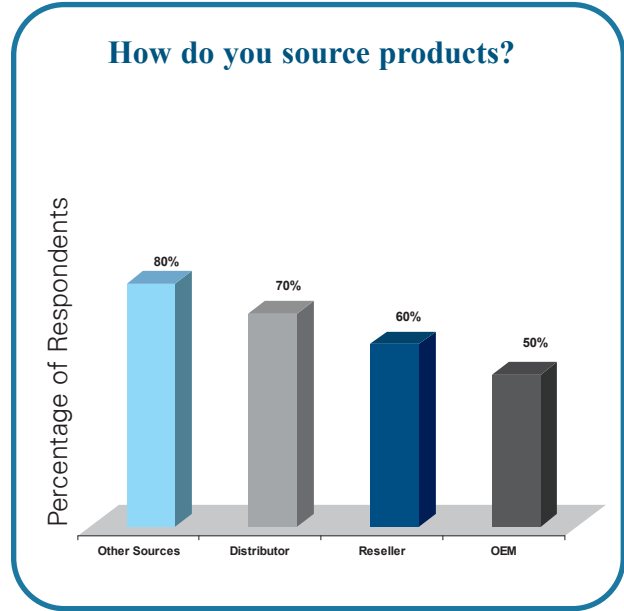
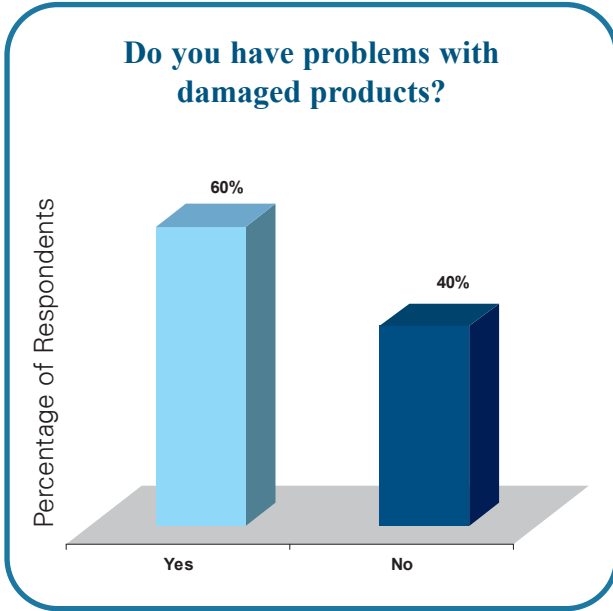
APPENDIX A: BROKER SURVEY RESULTS



APPENDIX A: BROKER SURVEY RESULTS

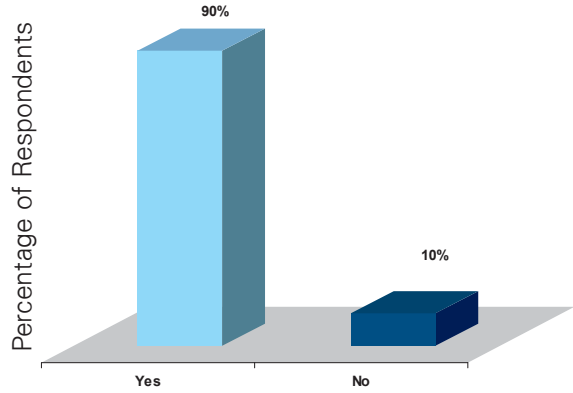


APPENDIX A: BROKER SURVEY RESULTS

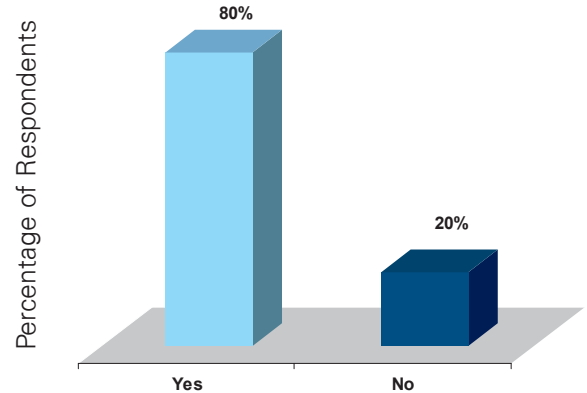


APPENDIX A: BROKER SURVEY RESULTS

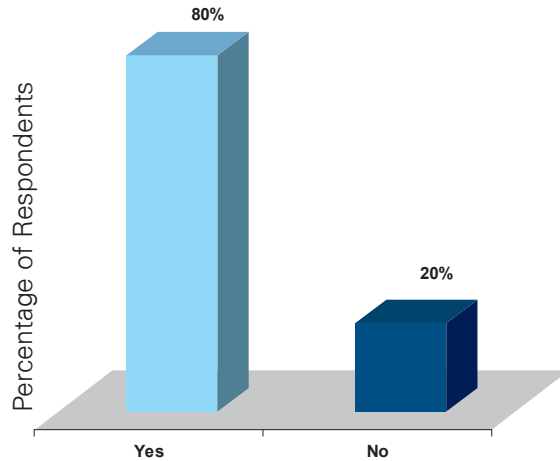
Do you sell to European countries?



Do you sell to Asian countries?

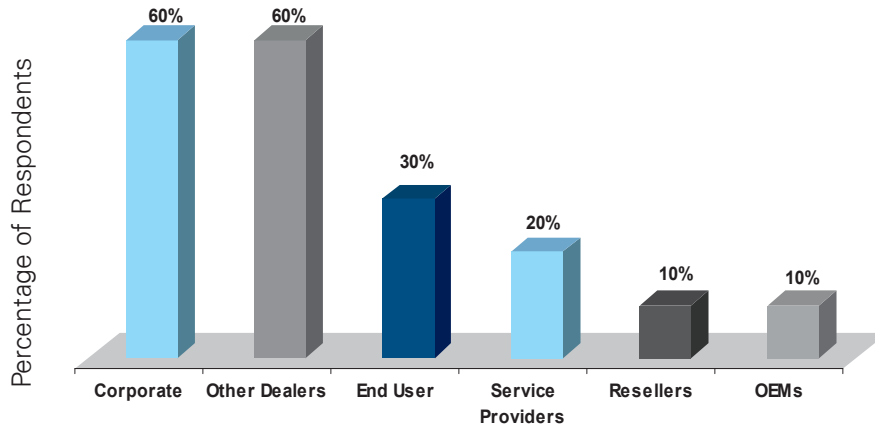


Do you sell to Latin American countries?

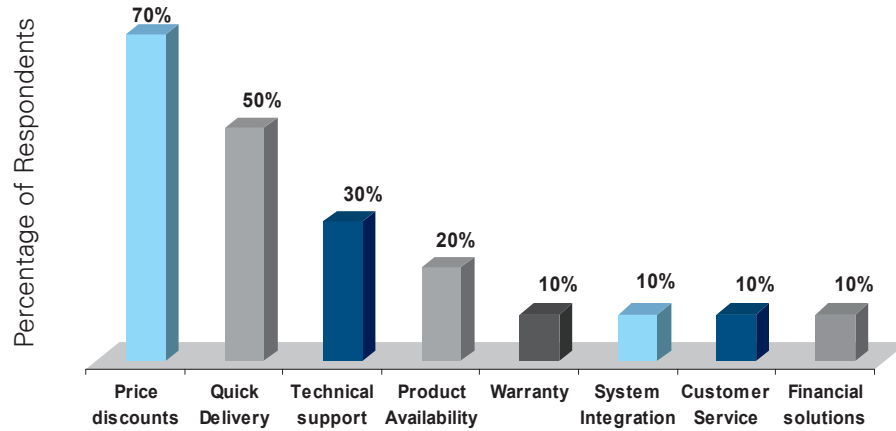


APPENDIX A: BROKER SURVEY RESULTS

Who are your targeted customers?

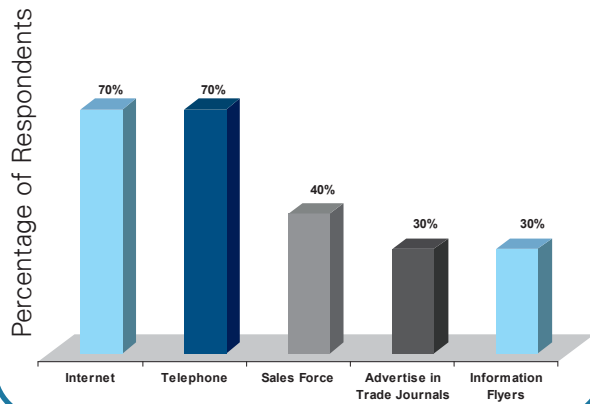


What value do you provide to your customer?

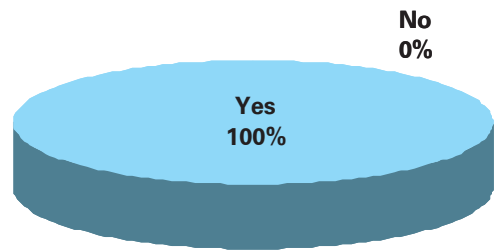


APPENDIX A: BROKER SURVEY RESULTS

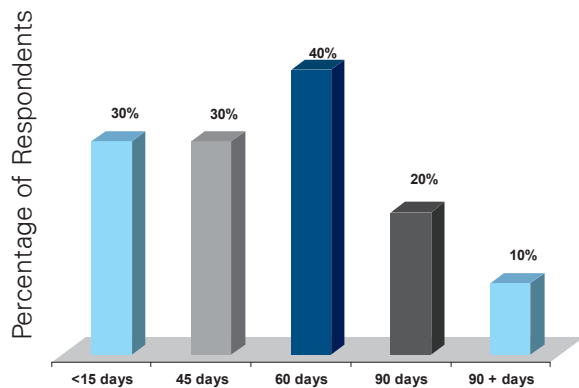
How do you promote your products to your customers?



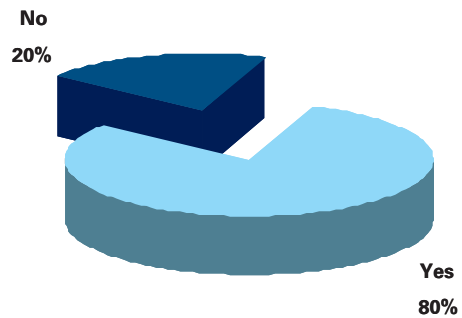
Do you hold inventory?



How many days of inventory do you hold?

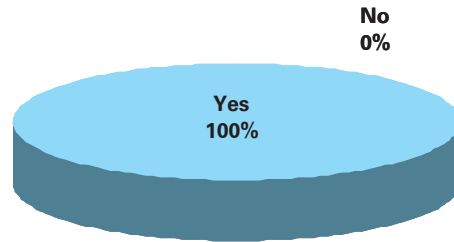


Do you track serial numbers?

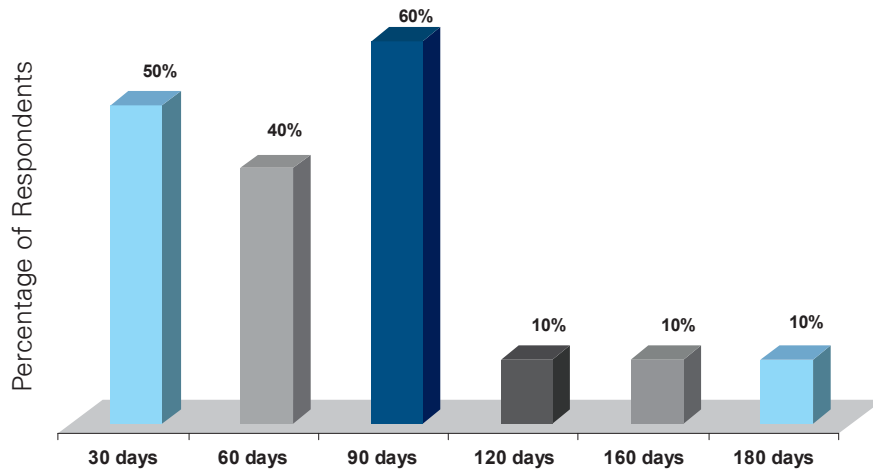


APPENDIX A: BROKER SURVEY RESULTS

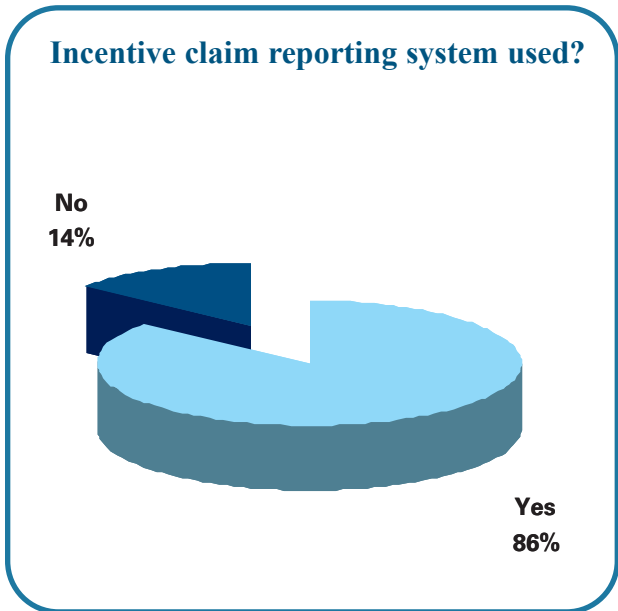
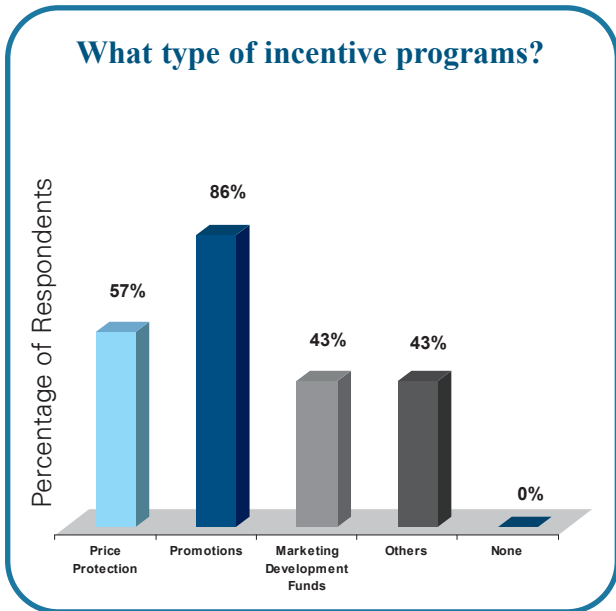
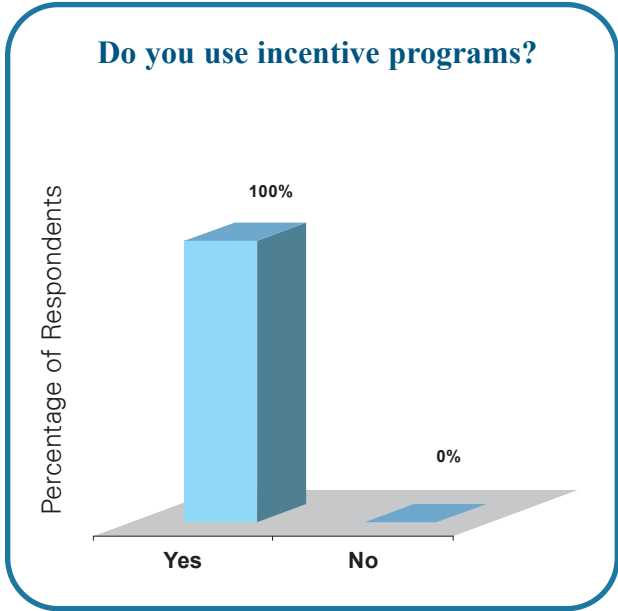
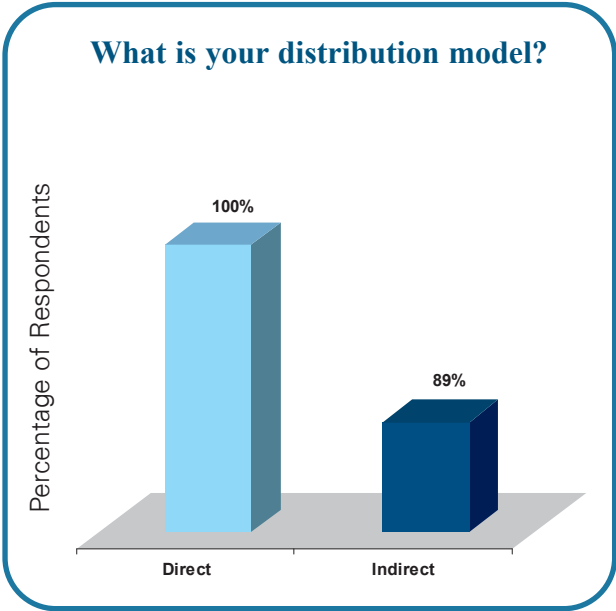
Does your company provide warranty support to your customers?



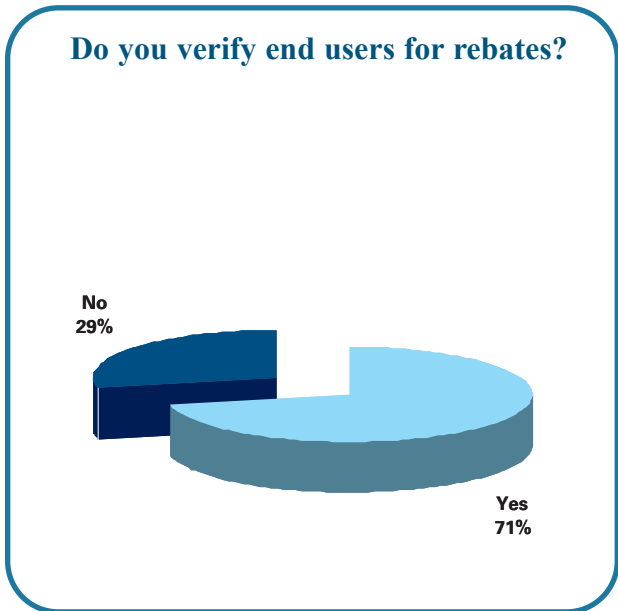
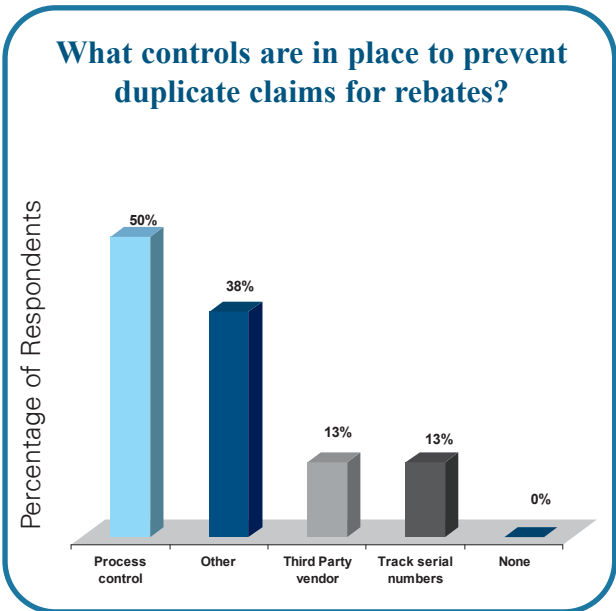
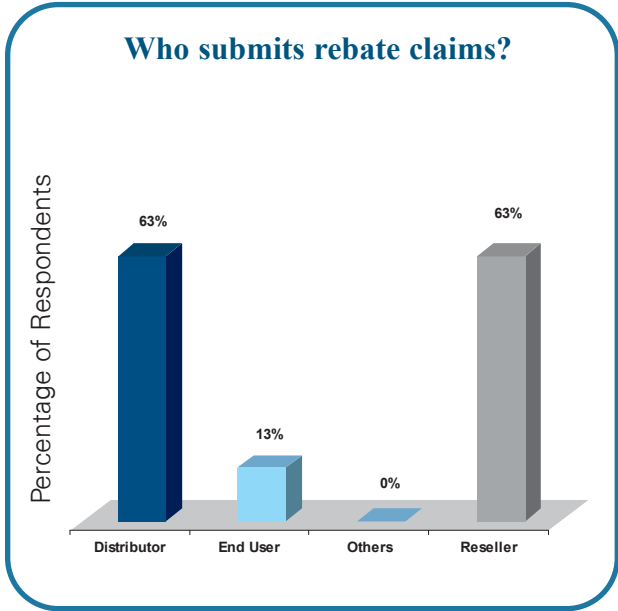
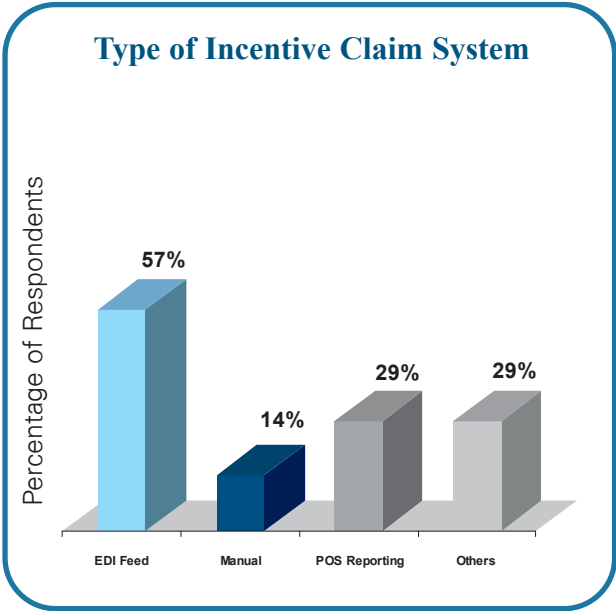
How many days of warranty do you provide?



APPENDIX B: OEM SURVEY RESULTS

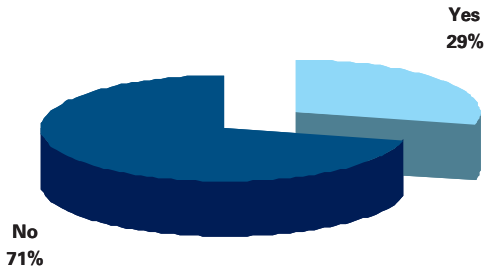


APPENDIX B: OEM SURVEY RESULTS

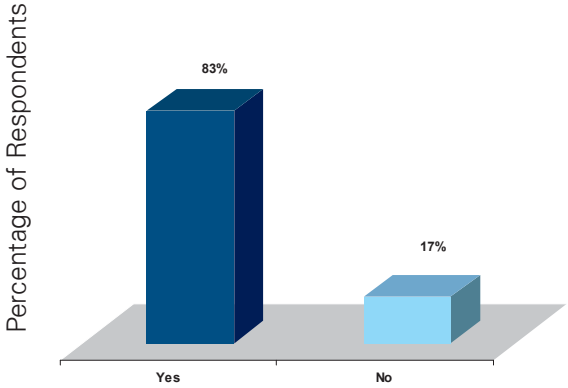


APPENDIX B: OEM SURVEY RESULTS

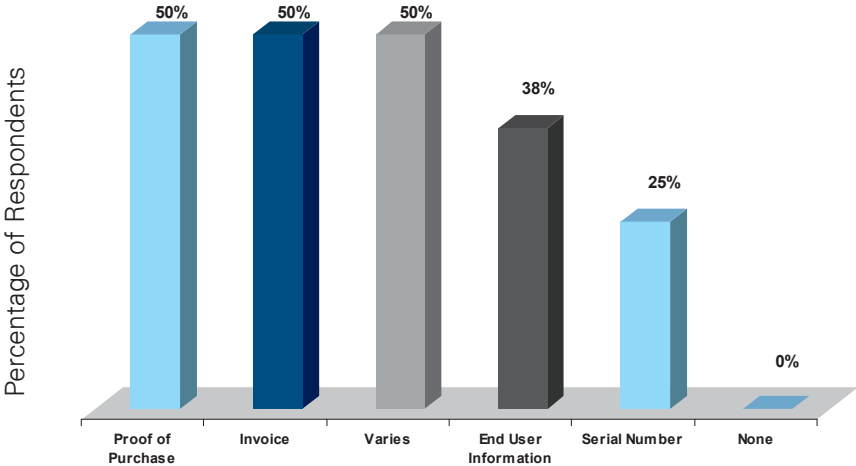
Is your end user verification process consistent globally?



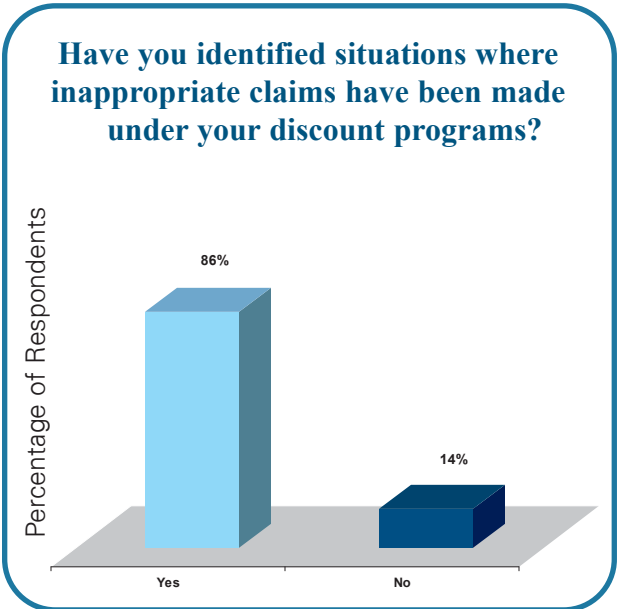
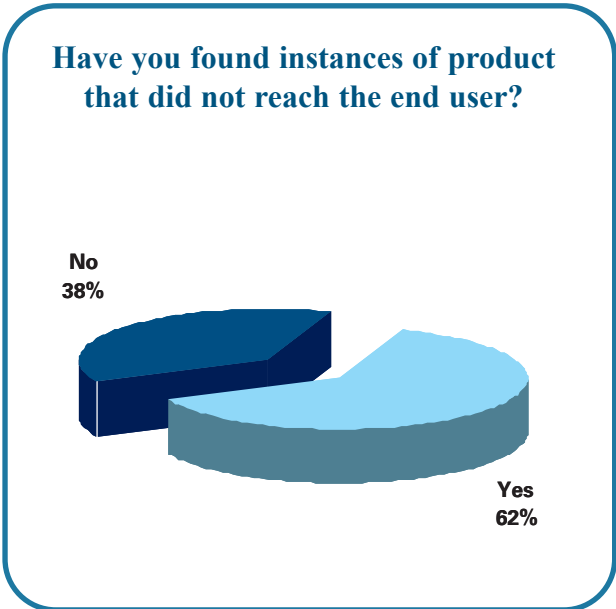
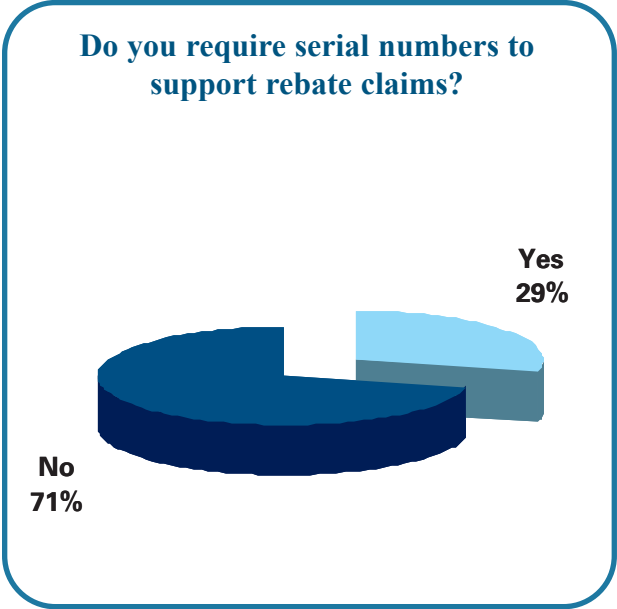
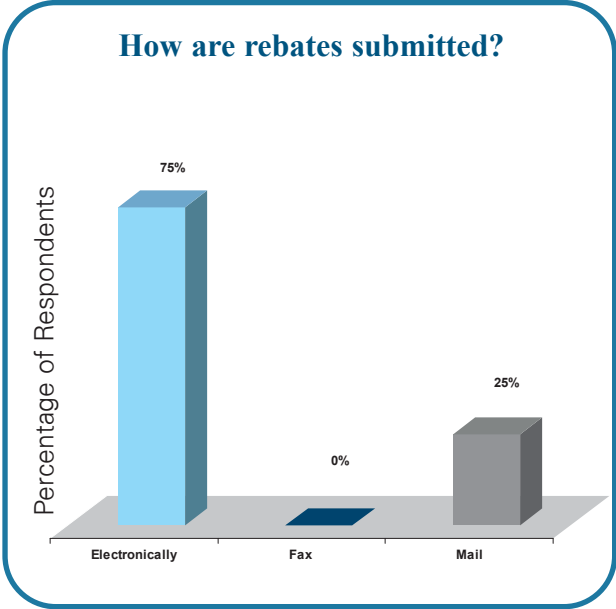
Do you require end user documentation?



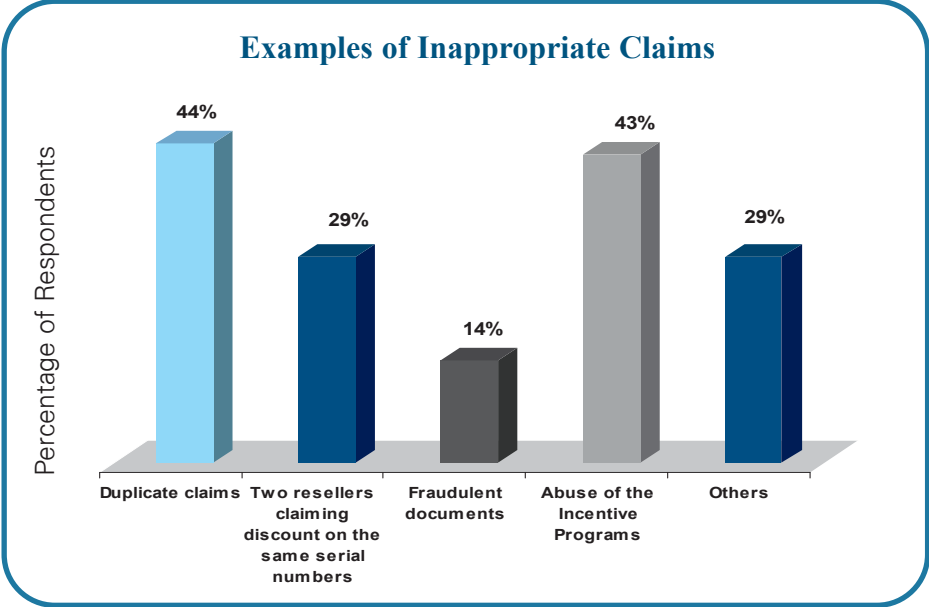
What documents do you require for rebate claims?



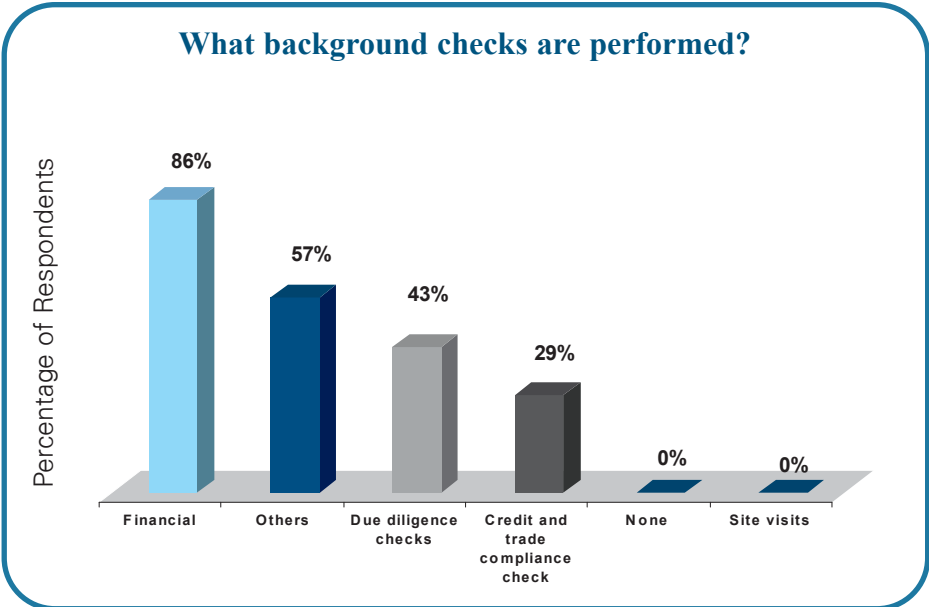
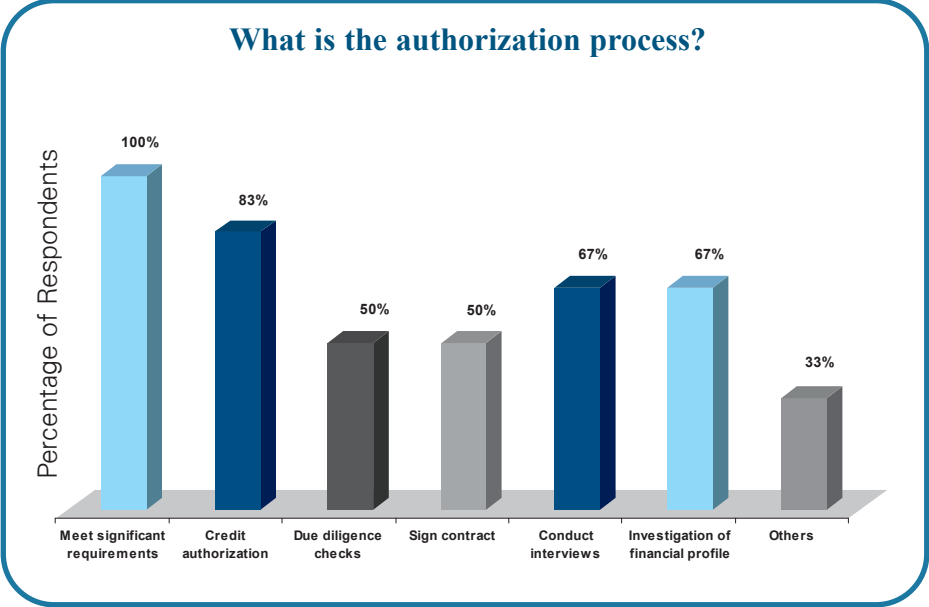
APPENDIX B: OEM SURVEY RESULTS



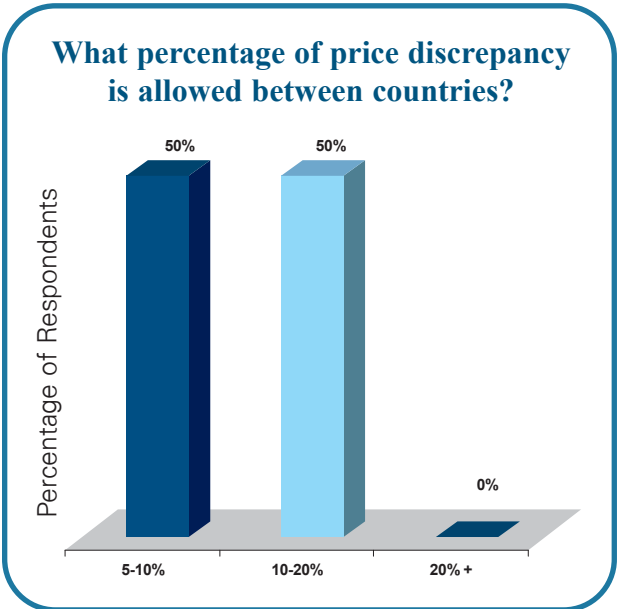
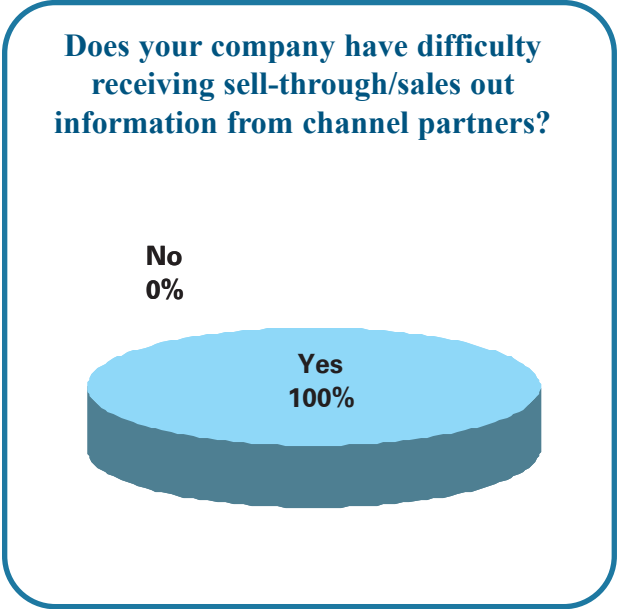
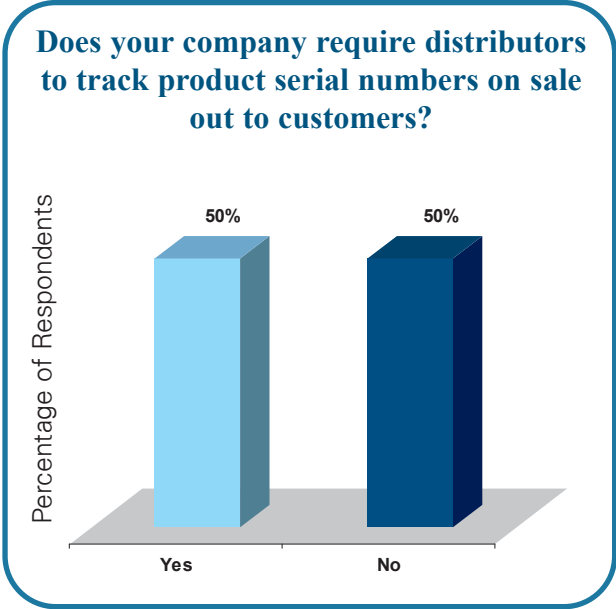
APPENDIX B: OEM SURVEY RESULTS



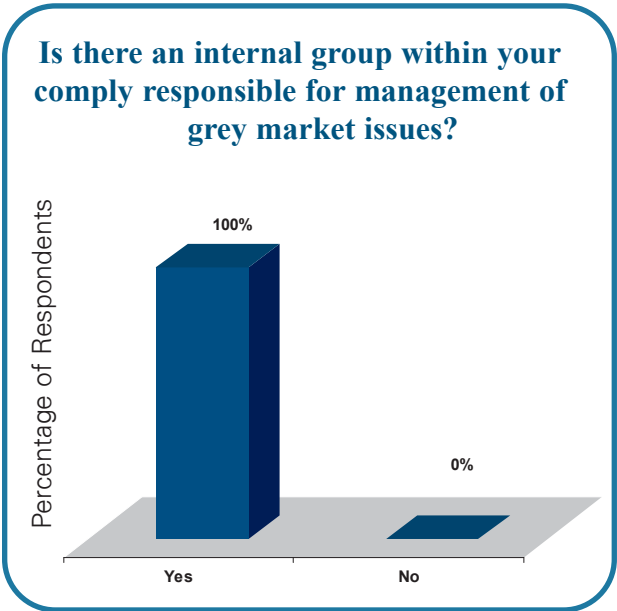
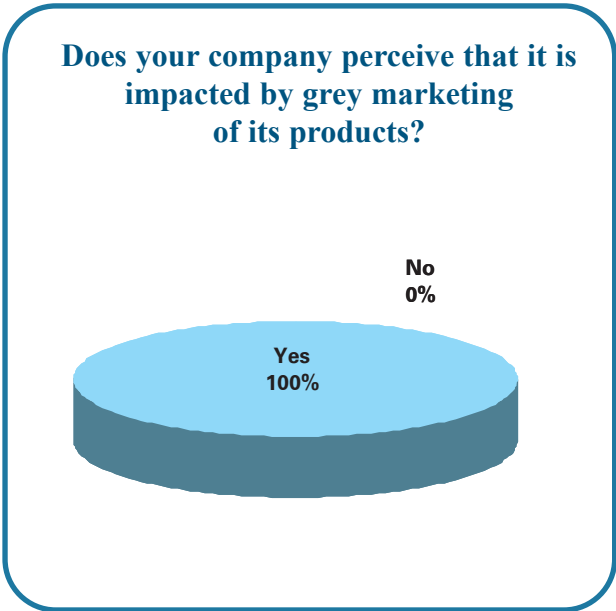
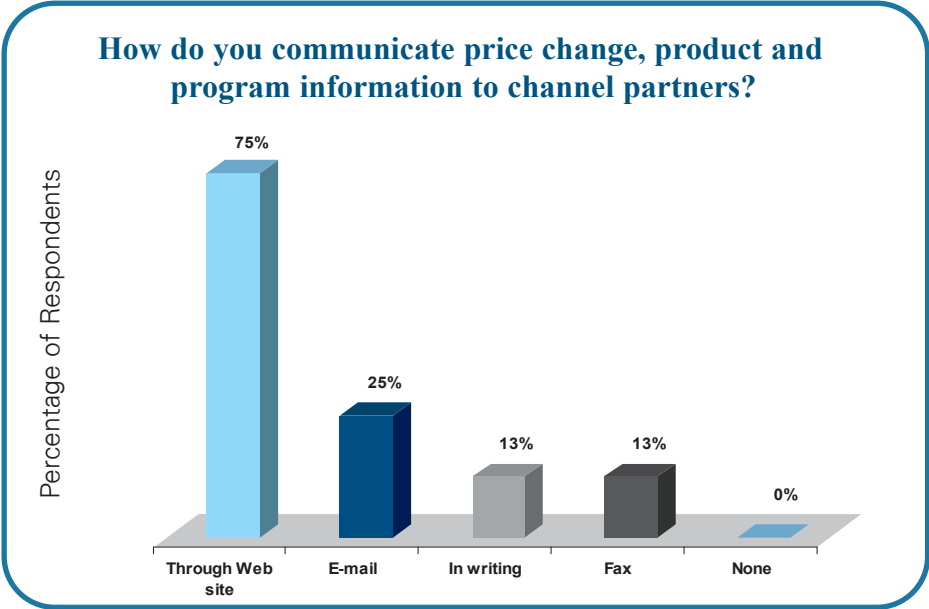
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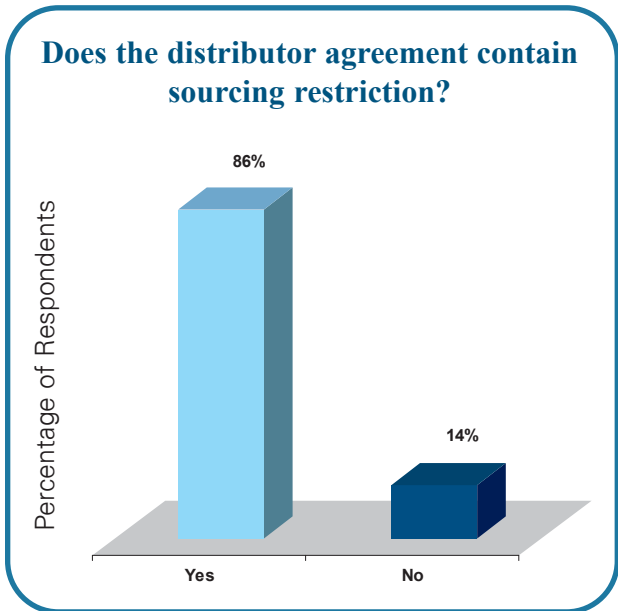
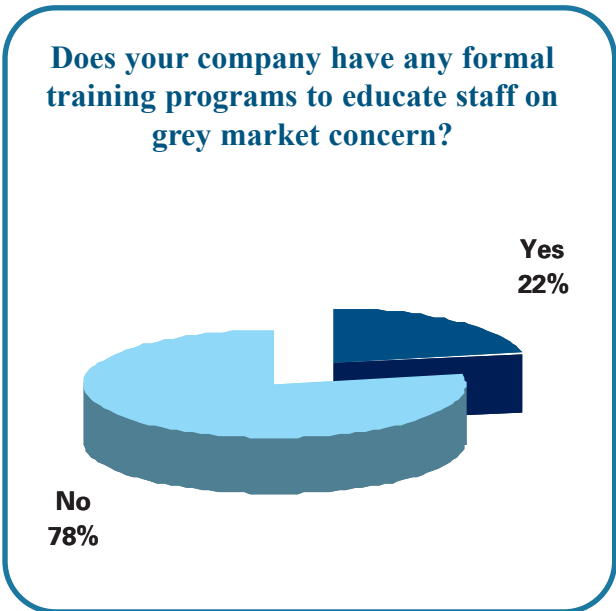
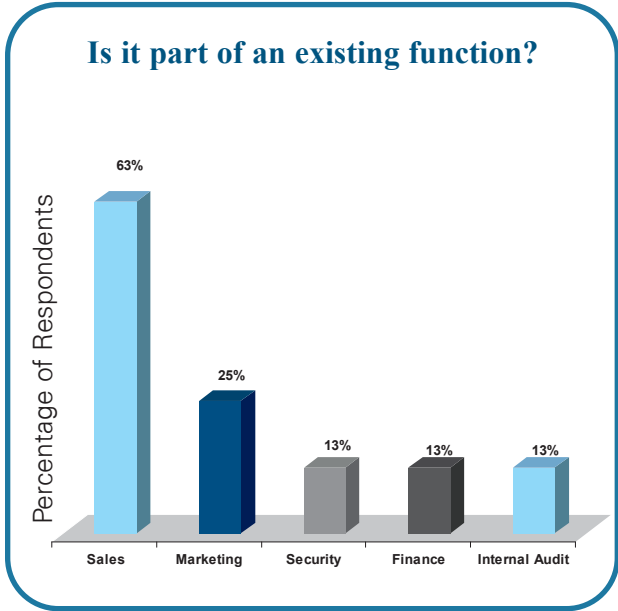
APPENDIX B: OEM SURVEY RESULTS



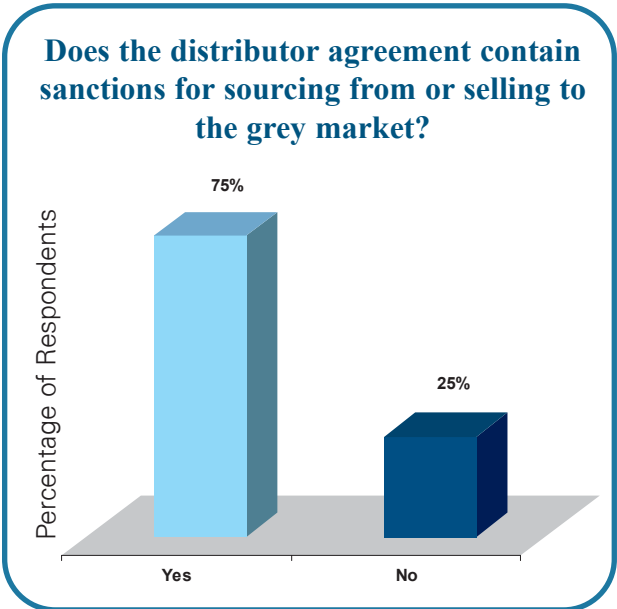
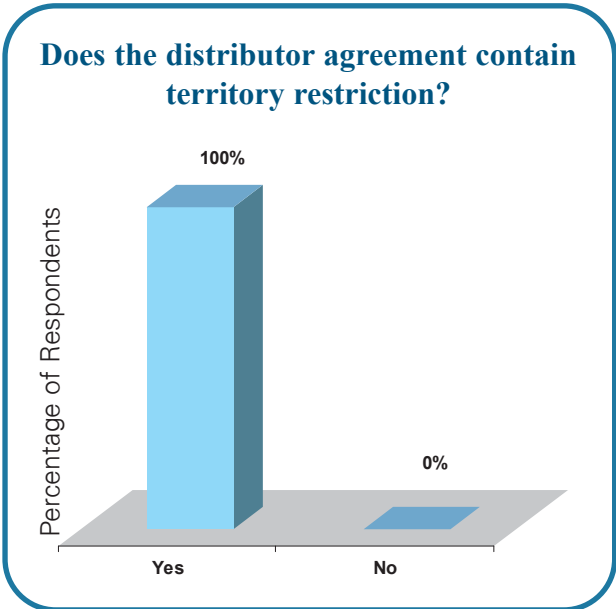
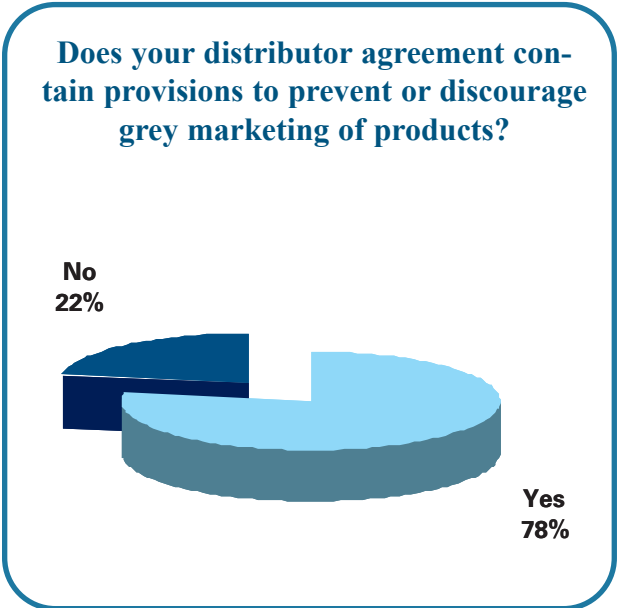
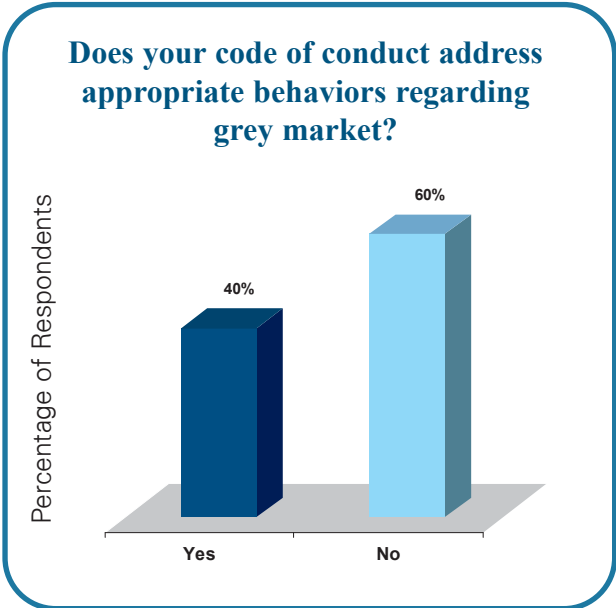
APPENDIX B: OEM SURVEY RESULTS



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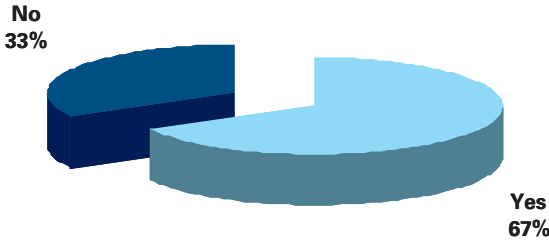


APPENDIX B: OEM SURVEY RESULTS

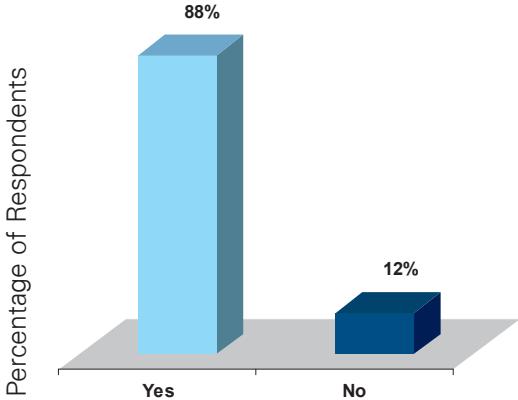


APPENDIX B: OEM SURVEY RESULTS

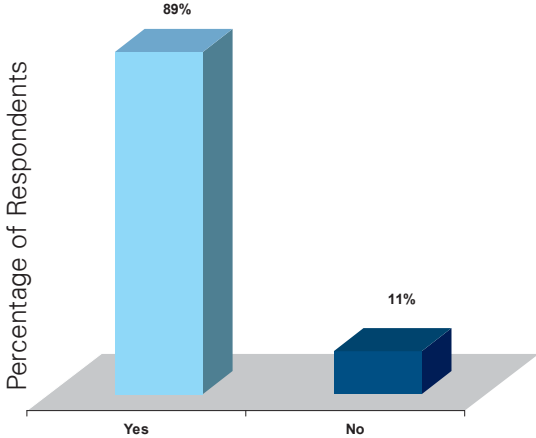
Do reseller agreements contain provisions to prevent or discourage the grey marketing of products?



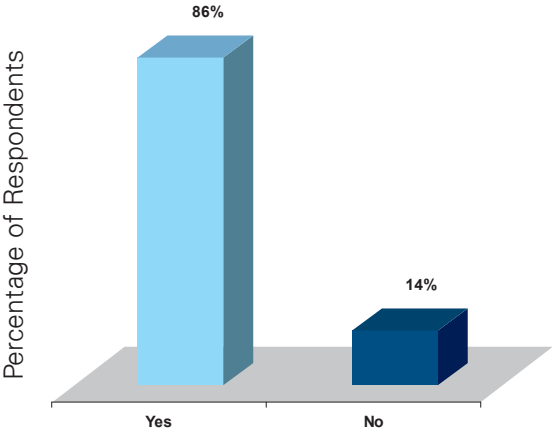
Does the reseller agreement contain sourcing restriction?



Does the reseller agreement contain territory restriction?

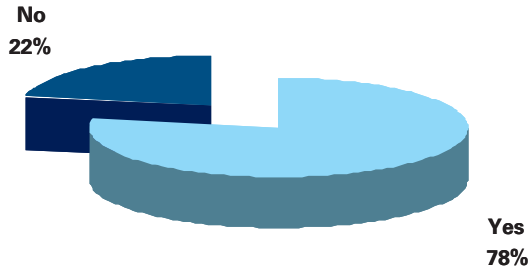


Does the agreement contain sanctions for sourcing from or selling to the grey market?

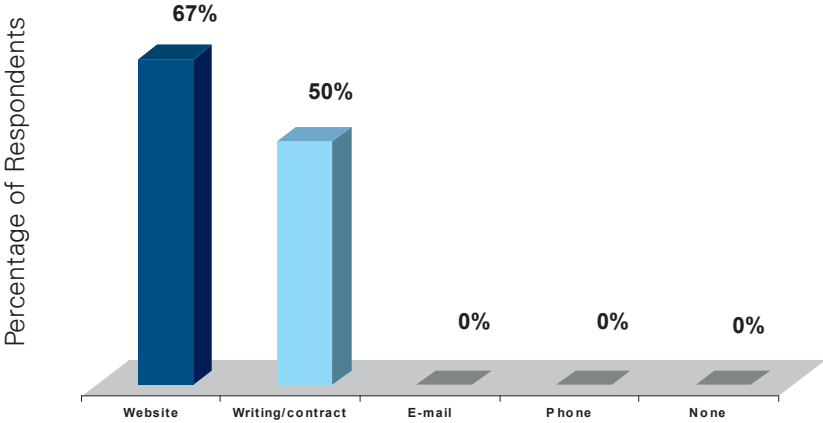


APPENDIX B: OEM SURVEY RESULTS

Does your company support warranty service on products sourced from the grey market?

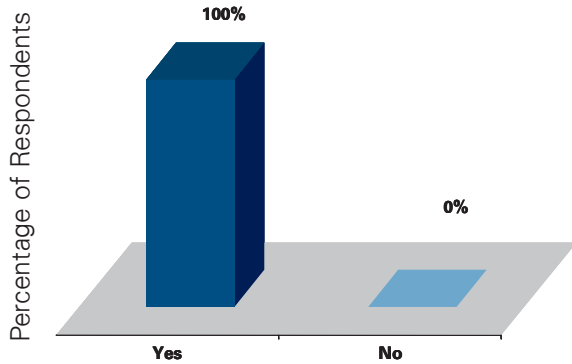


How is your policy communicated to the end-user/customer, or distributor partner?

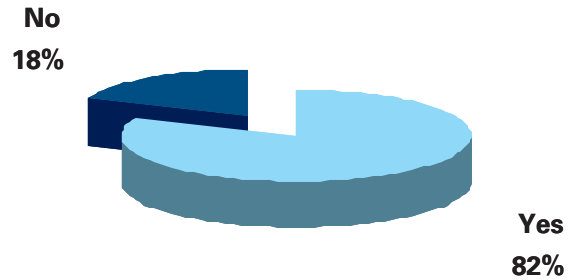


APPENDIX C: DISTRIBUTION PARTNER SURVEY RESULTS

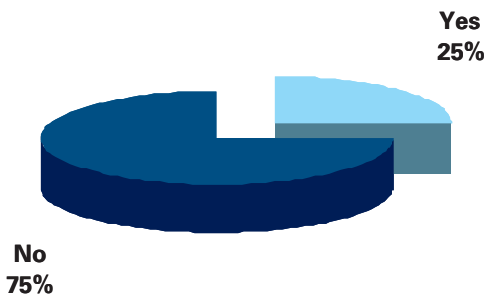
Do you find that organizations that are not authorized to sell OEM product are able to offer OEM products to your end users at prices lower than you?



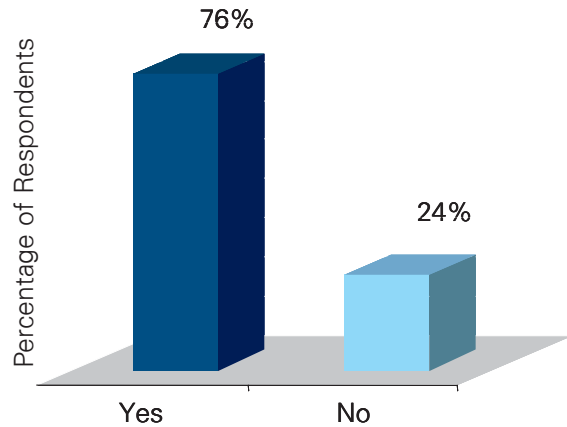
Do you believe your competitive position would be enhanced if all grey market activities were eliminated?



Have you received product returns of OEM product that was not procured within the country where you reside?

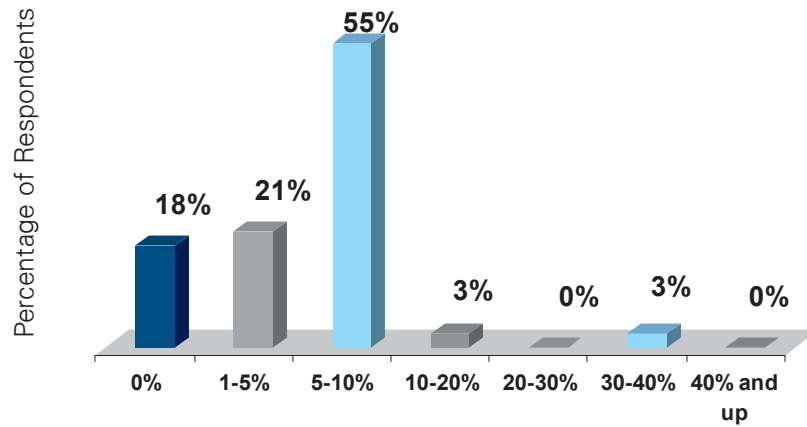


Is it necessary to purchase product from the grey market?

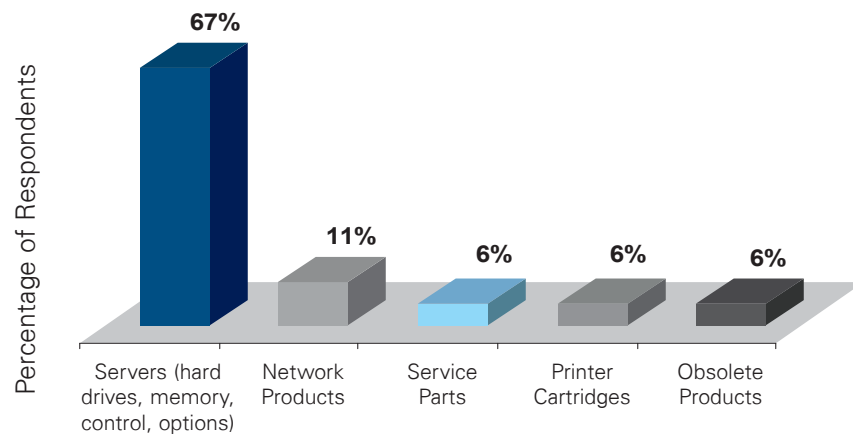


APPENDIX C: DISTRIBUTION PARTNER SURVEY RESULTS

What percentage of total annual purchases are made from the grey market?

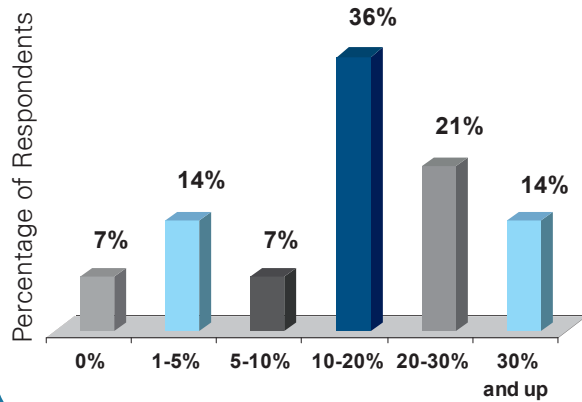


What types of products do you purchase from the grey market?

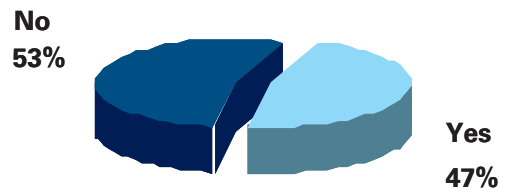


APPENDIX C: DISTRIBUTION PARTNER SURVEY RESULTS

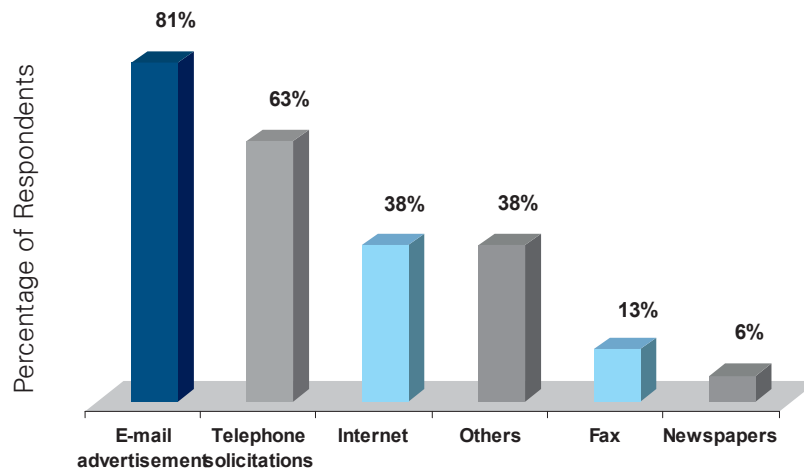
What range of price advantage is obtained on grey market sourced product?



Do you have a process to identify which products you source from the grey market which you source from OEM?

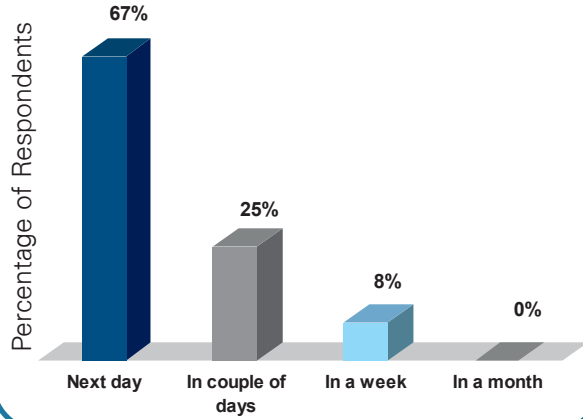


How do you find out about grey market offers?

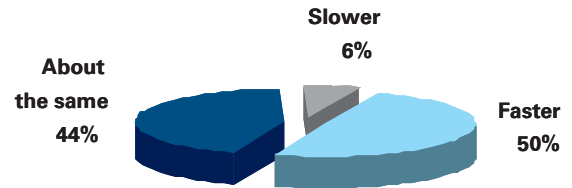


APPENDIX C: DISTRIBUTION PARTNER SURVEY RESULTS

How quickly do you receive product when it is purchased from the grey market?



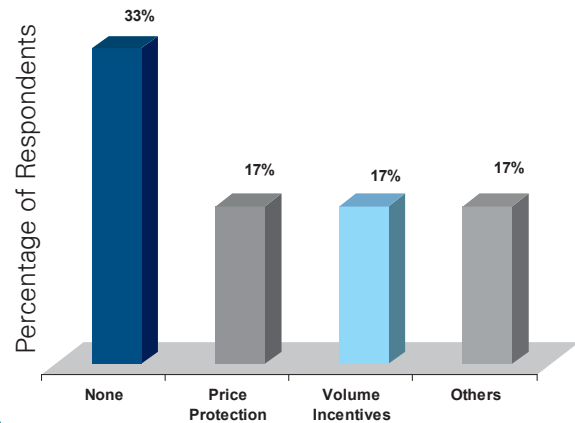
Is this typically faster, slower or about the same delivery as when you place an order from an OEM?



Do you receive any incentives to purchase product from the grey market?



Types of incentives from Grey Market?

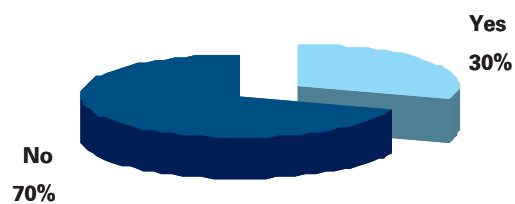


APPENDIX C: DISTRIBUTION PARTNER SURVEY RESULTS

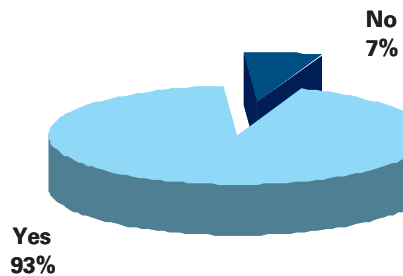
Are you able to purchase OEM product in one country at a price advantage and move it to another country for sale?



Do you include grey market sourced product under discount programs provided by OEMs?



When you purchase grey market product, are you concerned about sourcing damaged or counterfeit products?

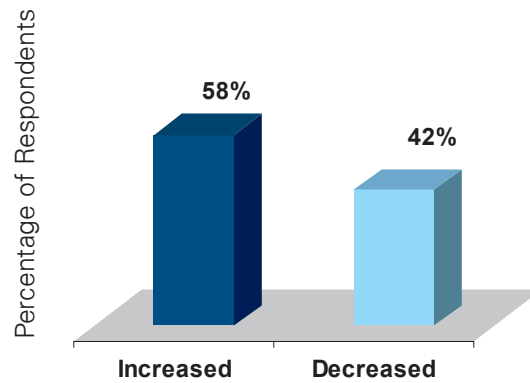


Have you actually experienced this occurrence?

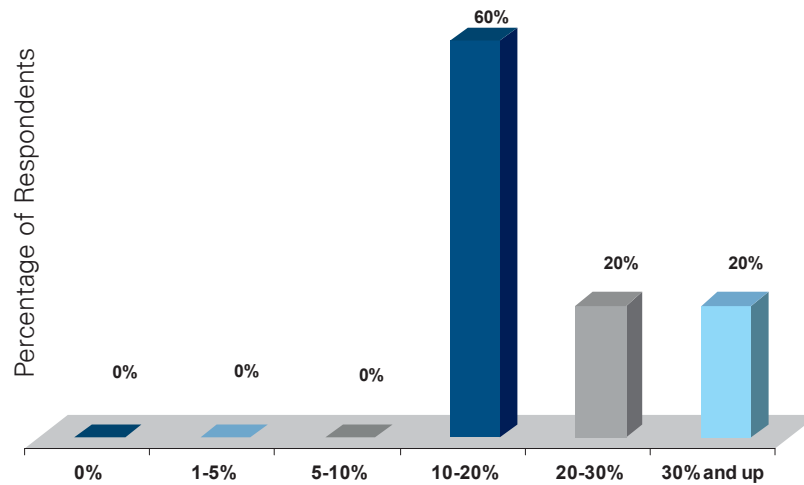


APPENDIX C: DISTRIBUTION PARTNER SURVEY RESULTS

Has the amount of product available in the grey market increased or decreased in recent years?

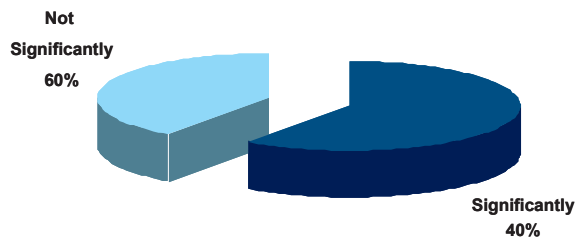


If yes, by what percentage?

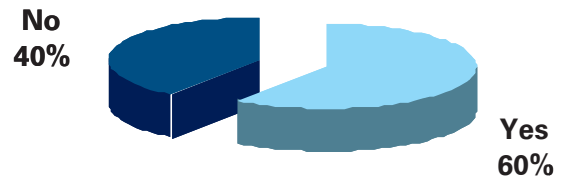


APPENDIX C: DISTRIBUTION PARTNER SURVEY RESULTS

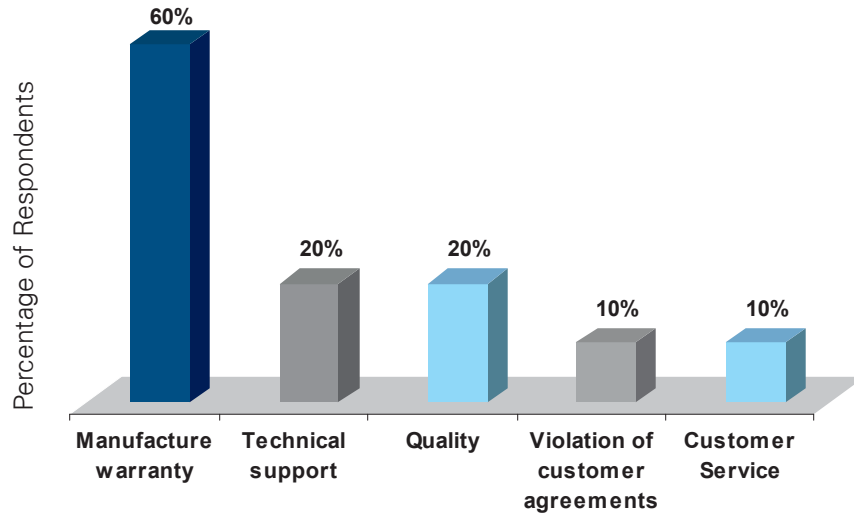
How does the grey market impact end user customer price?



Do you have concerns about selling grey market product to your end customers?



If yes, why?





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About AGMA

AGMA's principle purpose is to mitigate the gray marketing and counterfeiting of high technology products through implementation of brand protection practices and controls that will effectively render the movement of these products difficult, undesirable and unprofitable. By utilizing all legal avenues, AGMA members seek to deter criminal activities that feed the Gray Market.

As an umbrella organization, whose members' combined annual revenues exceed \$140 billion, our goal is to ensure the highest product quality standards, uphold customer satisfaction, protect brand integrity, improve standards for intellectual property enforcement, and ultimately stem the flow of IT product into the gray market.

For more information about AGMA, please consult the AGMA website at www.antigraymarket.org, or contact AGMA Vice President Marla Briscoe at marla.briscoe@hp.com or 281.518.7818.