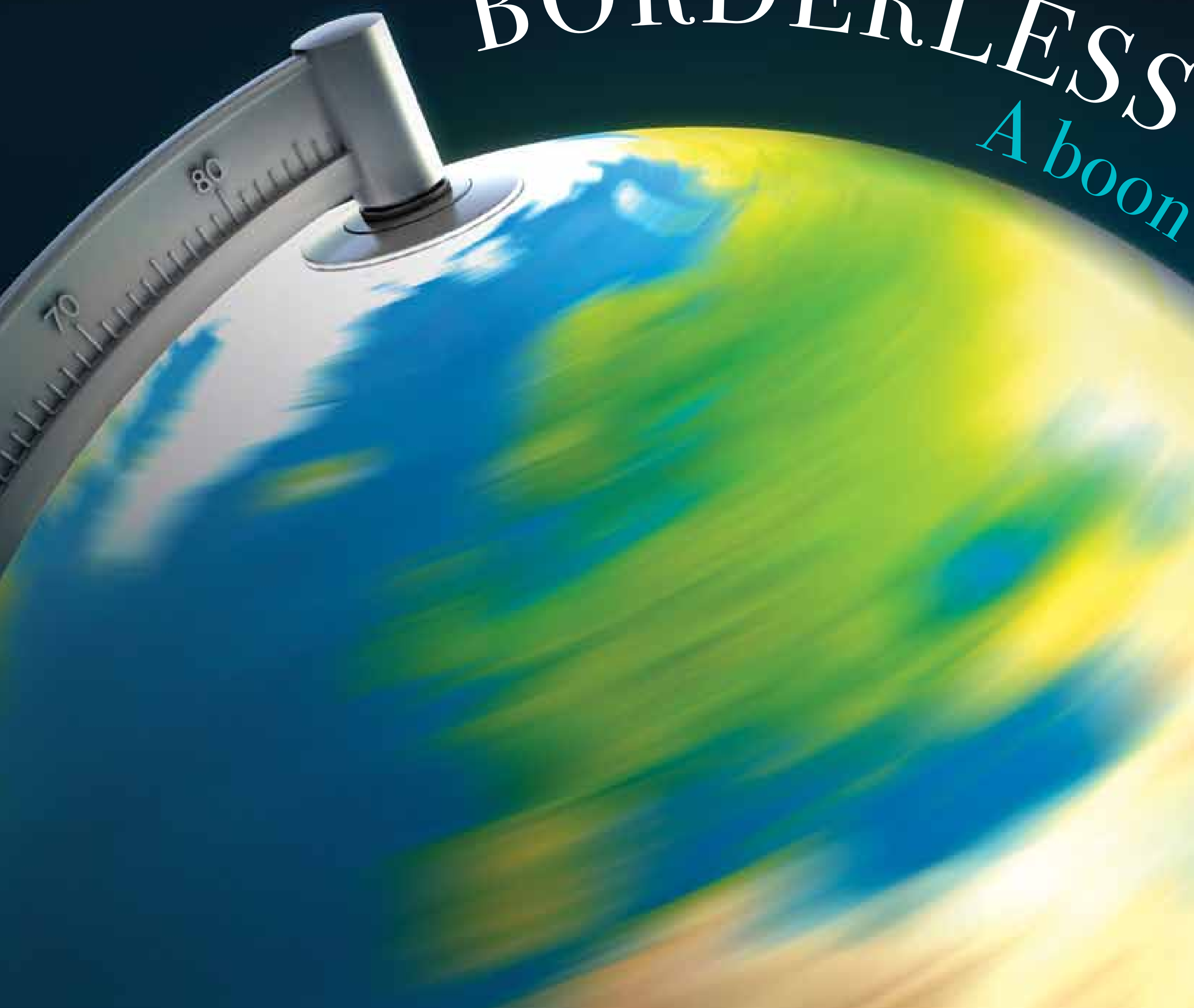
BORDERLESS

A boon



MARKETS:
or bane for marketers?

Economic integration and free trade is not always a panacea for businesses.

By Philip Zerrillo

Many prognosticators and pundits have extolled the virtues and concerns of the impending ASEAN Economic Community (AEC). The blending of markets and the reduction of trade and entry barriers are being hailed for bringing long-term competitiveness and attracting foreign investment into a fast-growing market of over 600 million consumers. For policymakers, a common market helps lower prices over the long run, which in turn benefits consumers.

On the flip side though, the coming together of the AEC brings about a series of fundamental changes in the nature of competition at the firm level. The reduction of tariffs and the hypothetical free flow of goods and services across borders will certainly open up opportunities, but equally, will inevitably change the competitive dynamics of many industries. Much of this competition will be felt in the marketing function, particularly in the distribution sector, and will lead to radically changed roles for marketers. Economic theory would imply that market homogenisation would simplify the marketing function as a potentially large market size should mean that marketers would be able to sell large quantities of their products, thereby benefiting from economies of scale—however, this is a rather simplistic description.

In reality, the coming together of ASEAN economies will strip the marketing function of one of its most important levers—the ability to price discriminate across markets. Pricing is a key tool in the marketer's arsenal as it allows them to customise prices to regional and local market conditions, in this manner extracting the maximum value for their products and services across markets and geographies. It also enables marketers to use prices to adjust supply levels to changes in demand, thereby optimising manufacturing and delivery scale. Moreover, marketers often use incremental cost plus pricing as a means to achieve efficiencies and enter new markets, as prices are set according to what each market will bear. But an integrated market takes away this ability to differentiate the product through price discrimination. This may not only lower the price, but also sets the stage for severe price competition if the company chooses to continue using price as the basis of competition, or continues to allow different levels of the channel the latitude to set prices. Businesses would then have to find other ways to differentiate their product offerings to their customers—which makes the task of marketers far more difficult and complicated.

Arbitrage: A key driver of grey markets

Let's take, for example, something as simple as music CDs or movie DVDs. In the past, producers would create the intellectual property and sell it in their home market (which, let us assume, is native English-speaking) at a price that would maximise the firm's earnings. Other regional markets would be treated as incremental, and the producing firm would sell the music and movies at a discounted price in order to attract international followers in those markets where English is a second language. Small to moderate sales levels would be achieved, but the cost of intellectual property development is already sunk, and thus the manufacturing, or in this case, mere duplication, costs would be trivial. These secondary market sales would be profitable when analysed on an incremental cost-to-revenue basis.

However, when markets integrate and borders become seamless, the goods that are intended for the second language market can be shipped back to the home market if there is an opportunity for price arbitrage. Thus the prospect to penetrate distant markets with low prices (supported by the previous investment in intellectual property development) is more difficult as the integrated market migrates, on its own, to a single, low price.

This gives rise to 'grey markets'– defined as goods, which show up in a market or channel for which they were not otherwise intended. Grey markets arise due to the potential for price arbitrage, whereby a product can be bought in one market or geography and sold in another, with a monetary gain to be realised from the prevailing price differential. Borderless markets inherently face the challenge of grey markets, as they tend to crop up the moment there is a difference in pricing and availability across markets. Because of this market imperfection, a very important marketing tool for developing secondary and emerging markets, namely price, is blunted.

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While the example of movies or music CDs does not evoke great sympathy from either lawmakers or consumers, the concerns rise when one considers the potential implications that can come about in the distribution and marketing of say, medical devices, pharmaceutical products and even healthcare itself. Currently, pharmaceutical and medical device companies look at markets according to their ability to pay. With heavy upfront R&D costs and a patent period that shields them from competition for some time, these companies generally look to the highest priced markets first, and try to secure the distribution and usage in those markets at an appropriate price that balances (relatively lower) volume with (relatively higher) price to maximise gross margin. As they already own the intellectual property, these firms would then sell those products at lower prices in developing economies, looking towards higher volume to enhance their overall margins—a strategy that is mutually beneficial for the company and consumers. The company gains by getting a foothold in those markets, and the populace of these lower income markets are able to receive discounted drugs and devices that could improve the standard of medical care.

However, if markets are seamless and these goods can be purchased and arbitraged across borders that price differently, then medical device and pharmaceutical firms may choose to avoid these lower priced markets completely, or at the very least, choose to price at the same high price of the developed markets. This would not only inhibit the company's future expansion, but also deprive patients in lower income nations of the latest medical technology.

How grey markets develop

As geographical borders become more porous, the threat of grey markets grows tremendously. In addition, there are other contributing factors that drive these

WHAT ARE GREY MARKETS?

Grey market goods, or 'parallel imports', is a term used to refer to genuine branded goods obtained from one market (that is, a country or economic area) that are subsequently imported into another market, and sold there without the consent of the owner of the trademark.

The goods are genuine goods (and not counterfeit items), in that they have been manufactured by or for or under license from the brand owner. However, they have been formulated or packaged for a particular market, and then imported into a market not intended by the brand owner.

Source: International Trademark Association, Factsheet grey opportunities. The **innovation and enhancements in packaging materials**, and their acceptance over the past 20 years, has been nothing short of staggering. The development of better, safer and more protective packaging (as well as advances in shipping services) allows for the transportation of goods erstwhile considered impossible. Today, medical waste, syringes and even controlled substances can be shipped in approved containers via common mailing methods. Admittedly, this option can work only if the additional cost of packaging and shipping does not reduce or offset the gain from the price differential. The Internet has made possible seamless **access to information on product prices and availability**. Consumers today have visibility on the price, selection, terms and availability of products in distant markets–and all this is taking place in a manner that has never been witnessed before, and will only continue to progress. Finally, **movements in currency exchange rates** are also a common trigger for price arbitrage, thereby creating a potential for grey markets. A confluence of these four factors–regional integration; packing and shipping efficiency and effectiveness; information immediacy and transparency provided by the Internet; and currency exchange fluctuations–has fuelled the growth of grey markets worldwide.

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Grey markets can manifest themselves in several ways. One such form is referred to as **International Distribution Diversion**, whereby a product that is meant for one country or region ends up in another. For example, when Unilever left Myanmar in 2000, Lux soap continued to make its way into the country from Thailand. Another form is **Domestic Distribution Diversion**, which happens when a product is sold in the same country, but in a different outlet than the one it was intended for. For instance, Courts, the electronics retailer, may decide to offload some products that it has not been able to sell (or have not proved popular with its clientele) to a discount store. The same is the case when luxury brands are sold through discount retailers. And finally, yet another manifestation of grey markets is **Reseller Position Change**, which refers to grey markets that develop when a company changes its position in the distribution channel. An example here would be say, a reseller of IBM laptops, who may decide to pool together the orders of smaller resellers in order to benefit from the discount IBM offers on bulk purchases. The reseller is able to fulfil a bulk order on laptops at a heavily discounted price, and the gains are shared between the main reseller and the smaller resellers. By doing so, the reseller changes his position to that of a distributor.

Repercussions of grey markets

The resellers that choose to trade in grey market products generally see the opportunity for easy profit with limited risk. Therefore, the category of products that are most likely to attract grey markets are typically branded goods, and those where the legitimate channel adds considerable value, that is, commands high margins. These are usually popular goods from well-known brands, as their significant margins can be adjusted to gain sales volume, often at the expense of the legitimate channel.

While grey markets expand the distribution reach of products, they do not in any way contribute to the building of the brand. The looming problem for brand owners is that as the grey market emerges, the legitimate channel starts to see a reduction in their sales volume as these free-riding grey market sellers add very limited support to building the brand—choosing to compete purely on price, rather than adding on services such as product support, warranty and training.

The retailers that truly add value begin to lose confidence in the brand and would either lower their level of services or stop selling it altogether, both of which put the owner in the difficult position of presiding over an eroding brand that has declining channel support. Worse yet, they have a brand that is increasingly dependent on the efforts of resellers who have no relationship or contractual commitment to the manufacturer. Companies thus go to great lengths to circumvent grey markets in order to protect their brand from being diluted, especially when value-adding services are needed.

Emerging channel strategies for the AEC

As stated earlier, AEC integration does indeed provide opportunities for access, but it also provides great opportunities for the spirit and intent of existing distribution arrangements to be challenged. A multinational company targeting this region will need to consider the advantages and disadvantages of selling in an integrated market. Much of the decision has to do with volume of sales versus consistency of the overall offering. Some firms will crave sales and market penetration while others will seek greater control of their distribution channel so as to provide a coordinated positioning in the market.

CONTROL

For those looking at coordination, we are beginning to see the emergence of multi-market, multi-brand distributors such as the Primer group out of the Philippines. Primer works across 18 countries and represents roughly 80 premium brands and 160 free-standing stores.[1] The geographical expanse of such a firm provides an opportunity for a one-stop distribution agreement with the brand owners. They can place their brands in the hands of one distributor who is in touch with the multiple markets and has the same interests as the brand owner. Instead of having two resellers in neighbouring countries competing to offer the lowest price, the distributor (Primer) now works to find the 'right price' while protecting the integrity of markets.

The Primer group operates both free-standing store formats as well as multi-brand stores. This provides an opportunity for both Primer and their brand partners to experiment with the brand and determine the best distribution format. This format also offers nascent brands an opportunity to test new markets in multi-brand formats before going to full scale, free-standing stores.

PENETRATION

Multinationals often struggle to effectively penetrate emerging markets. Many folks will chalk this up to the price of products and purchasing power in the local markets. But this is instead often a problem of finding distribution partners that can take products to the countryside beyond just the Tier I and Tier II cities. In many cases, with a large part of the country still living in primarily rural settings, multinationals find that the integrated market helps to get them to the Tier I cities, but beyond that, it is a challenge.

The Masan Group, one of Vietnam's leading fast moving consumer goods company, has realised the virtues of this path. The company has leveraged customer data and customer insights to determine its growth markets in terms of product categories, with a particular emphasis on dominating rural distribution networks.

Going with the flow

Firms can have very different philosophies when dealing with grey markets. At

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one end of the spectrum, companies such as Chanel and Tommy Hilfiger have a team of highly-paid web trawlers who scour the Web looking for sites that offer their products at heavily discounted prices. At the other end, some businesses find it easier to not only tolerate, but even benefit from the existence of grey markets. This is especially true for products that move into mass channels.

For instance, Minolta sold cameras to its distributors worldwide for roughly the same freight-on-board price. The sales channels in Asia retailed the product for approximately 60 percent more than the purchase cost, while their U.S. counterparts ran a very high-service channel and marked the product up by over 200 percent. When Minolta found that their home market cameras were washing up on the U.S. shores, the company preferred to turn a blind eye as it helped prop up sales and also gave it the much required volume to recover its fixed costs. This is not unusual for a stable product that no longer requires the service levels that it did once upon a time. When Minolta was a newcomer to the U.S. market, it needed strong reseller support to stand by its products, assist the customer and make sales. But as the product became technically stable, well known and easy to support, the company began to question whether the 200 percent margins were justified, or whether they were just limiting sales. Similarly, Wrigley chewing gum began printing prices on its gum packages when it saw that the convenience outlets were marking up the product so much that its volumes were beginning to reduce drastically.

Most companies will tolerate some grey market activity up to the point that it leads to incremental profits. However, it is a thin line to cross between an acceptable amount of 'leakage' into grey markets and jeopardising relationships with the trade or, worse still, customers' perception of the product in the high-priced segment. Beyond a certain level, all grey market activities damage the long-term profitability of a business.[2]

Tapping into the opportunities: Lessons for the future

With the advent of the AEC, distribution strategies and grey markets will need to be re-thought. In the presence of grey markets, managers will find themselves moving to a one-price policy across a homogenised market. But the great opportunity for marketers lies in their ability to recognise and satisfy the great heterogeneity that will continue to exist in these markets even as borders become porous and tariffs come down.

The winning firms will find alternate ways to differentiate their product offerings to their customers, such as bundling of products and services, product warranties and differentiated packaging. They will consider different strategies for rural versus urban distribution, and they will also be the firms that understand when it is better to work across regions rather than by countries.

There are other opportunities too. The AEC will allow companies to operate in multiple locations and therefore develop local specialties. So it will become easier for companies to source, manufacture and sell their goods in different countries across the region. Countries like Vietnam and Indonesia offer attractive manufacturing bases due to their low labour costs, and others like Singapore are attractive markets to sell in. However companies need to recognise that the distribution systems in those countries may not always be their best friends—retail laws and channel regulations may not always work in their favour. But for those prepared, the new economic bloc serves as an opportunity to differentiate themselves and drive long-term business performance.

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Reference

1 Primer Group of Companies, http://www.primegrp.com.

2 Gert Assmus and Carsten Wiese, "How to address the gray market threat using price coordination", Sloan Management Review, Spring 1995 Issue.