The Gray Market Blues

by Bill Freais, Apple Direct staff

Recently I discovered an effective way to sow dissention among people in our industry: Seat several of them around a small table and ask them to define "gray marketing." A free-for-all ensues.

Some immediately condemn fly-by-night international distribution outfits that dump products on foreign markets. Others decry non-U.S. resellers who bypass their own authorized distributors to acquire products directly from American suppliers. Still others complain that citizens of countries outside the U.S., who order software directly from U.S. mail-order houses instead of from their own local dealers, are causing the problem. And, yes, a vocal few finger tourists who pick up a Macintosh and a handful of software while vacationing here in the States.

Eventually, though, the dust settles, and when it does, nearly everyone agrees on this: Whatever its shade, gray marketing circumvents authorized channels to distribute products, and by so doing, it undermines the distribution systems software publishers rely on to sell software abroad. They also agree that something needs to be done about it now.

Shades of Gray. Several factors influence gray marketing: whether or not a product is available abroad in a localized version, for example; whether its latest revision is available; whether resellers can get it locally in quantity. But nothing seems to influence the gray market quite so directly as the combination of price

differential (the difference between what you pay for something abroad and what you pay for it here in the U.S.) and a non-U.S. population's familiarity with the English language.

The high-profile role of price differential shouldn't come as much of a surprise. Computer software and hardware are cheaper in the U.S. than they are abroad (although hardware represents only a minuscule portion of the gray market), and gray marketers take advantage of this fact of international commerce. For this reason, some argue that the gray market is simply an "alternative distribution channel," a natural by-product of free-market economies, and that authorized distributors should learn to face the reality of competition and lower their prices. (The more you learn about gray marketing, however, the less sense this argument makes.)

Combine price differential with the fact that a large part of the world's population is familiar with English, and you have the makings of a real problem for third parties trying to establish markets for American products abroad. In countries where English places a distant second or third to the native language, that problem is more or less nonexistent. In France and Italy, for instance, English is spoken by relatively few people, and there is virtually no gray market. The French and the Italians want localized products, and they're willing to pay for it—for the most part, they buy their software locally, and they buy it through authorized channels.

Gray Areas. In countries where English is either native or at least commonly used in business and education, however, gray marketing tends to thrive. Take, for example, Holland. In that country, fluency in English is common, and so,

therefore is gray marketing. Mail order accounts for the majority of gray-market activity there. The Dutch read Macworld, MacWEEK, and MacUser in English and therefore know what's available in the States and how much it costs. Jay McLaren of Signal, the largest authorized Macintosh distributor in Holland, Belgium, and Luxembourg, estimates that Signal loses between 30 and 40 percent of its high-end-software business to the gray market.

And yet Holland's gray market pales alongside that of Australia and the United Kingdom. In the U.K., English is the native language, and there are relatively few critical differences between software produced for that market and software produced for the U.S. Add to this the fact that, on average, software costs 25 percent more there than it does here (not to mention that the average citizen of the U.K. has half the disposable income we do), and you can see that there's little incentive for users to buy through authorized channels at home.

As in Holland, mail order accounts for a healthy portion of the U.K.'s gray market, but virtually every other gray-market practice is alive and well there too. According to Kevin Hawkins, managing director of Principal Distribution, Ltd., in Manchester, England, American wholesalers regularly sell products directly to dealers in the U.K. through catalogs, and some American software publishers offer 24-hour toll-free numbers to prospective users there. Worse still, there are resellers in the U.K. who handle nothing but gray-market products; they work directly with distributors in the U.S. to circumvent authorized distribution channels.

The situation in Australia is similar, but according to Peter Higgs, Apple Australia's third-party-marketing manager, "backyard operators" account for the

bulk of the problem there. These fly-by-night distribution operations set up mail-order businesses within the country and unload vast amounts of software at prices authorized distributors can't begin to match. Needless to say, these back-yard operators are the bane of the Australian value-added distributor.

Fade to Black. At this point, some of you are asking yourselves just what I asked myself when I began talking with people about gray marketing: What's the trouble with a little competition? Isn't this just the good ol' capitalist fire-sale ethic at work? Doesn't gray marketing simply increase the overall amount of software sold abroad, and isn't it therefore to everyone's advantage (with the possible exception of authorized distributors who, like monopolists everywhere, just want to legislate competition out of existence)? The answers to these questions are "nothing," "no," and "no," respectively.

Gray marketers and authorized distributors are competing, but they're not playing by the same rules. Value-added distributors abroad provide a wide range of services that are belied by the title "distributor." They not only move products from storage to reseller and ultimately into the hands of users, but they also localize products; create markets by investing heavily in advertising and marketing; and, perhaps most importantly, provide customer support. The value they contribute to a product abroad increases that product's worth, but it also increases their costs and makes it tough for them to reduce their selling price to compete with that of the gray market. Gray marketers, on the other hand, provide nothing but the product itself, and when users turn to them for support, they refer those users to authorized distributors. Thus gray marketing has more to do with parasitism than capitalism.

The argument that the gray market benefits almost everyone by providing yet another conduit for products to enter foreign markets is also anemic. Typically, gray-market activity doesn't begin until a product is well established within a market. At that point, gray marketers advertise prices that undercut those determined by value-added distributors. Naturally, a segment of the user population takes advantage of the gray market (everyone wants to save the equivalent of a buck), and consequently value-added-distributor unit sales decline. Over time, those unit sales decline so radically that it becomes unprofitable for the value-added distributor to continue supporting the gray-marketed product. And ultimately that spells the product's doom. Users are no longer able to get the support they need, and new markets are no longer cultivated.

Solutions in Gray. OK, so what to do? Well, price differential drives the gray market more than any other single factor. So one remedy for gray marketing is this: American software publishers (that's you) can help authorized distributors reduce the difference between prices here in the U.S. and prices abroad. By diminishing the price differential, you'll take the incentive out of the gray market.

One way to do this is to reassess the margins you give your non-U.S. distributors. According to Peter Higgs, many American software publishers (too many) give their non-U.S. distributors the same margin they give their domestic distributors. Unfortunately, this leaves distributors abroad no choice but to raise their prices substantially in order to pay for the value they add on their end. And this, of course, contributes to the gray market. Currently, American software in Australia sells for half again to twice what it costs here. Simply adjusting margins

to reflect the value authorized non-U.S. distributors add to your product abroad, Higgs feels, can reduce this differential significantly.

Localization also has demonstrable impact on the gray market. At first glance, it may seem as though a product developed for the American market would be directly transferable to any other English-speaking marketplace. Not so. Standards abroad are substantially different from what they are here in the U.S. In the U.K., for example, such things as page size, system of measurement, date format, and even the definitions of common words are unique. Microsoft and Claris, among others, account for these differences in their word processors by supplying localized page-size options, metric rulers, dates, and dictionaries that reflect the local language. Localizing manuals also provides incentive for users abroad to buy through their authorized channels.

Making current versions of your product available abroad also works against gray marketers. The fact that new versions of just about everything are released in the U.S. long before they're released abroad just invigorates the gray market. According to Principal Distribution's Kevin Hawkins, users in the U.K., who, you'll remember, are regularly exposed to ads in American industry publications, buy gray market simply because authorized channels don't yet have what they want.

There are also other ways to mitigate the effects of the gray market. Claris and Farallon, among others, prohibit their domestic distributors from selling their products abroad, and Claris signs exclusive contracts with its non-U.S. distributors. Numerous other software companies use stickers on all domestic stock that indicate that a given product is for distribution in the U.S. only, and they use different serial-number sequences for domestic and non-U.S. products.

And many are beginning to reevaluate their reliance on mail-order houses that focus on selling overseas.

But perhaps the most immediate and most effective measure American software publishers can take to stem gray-market activity is to begin working more closely with Apple's subsidiaries abroad. They are the experts on your international markets, and as your international sales become a larger part of your company's overall financial health, they will become more and more critical to your success.