

April 1990

SPECIAL REPORT

THE GRAY MARKET

THERE'S A SHADOWY
WORLD, BETWEEN CRIME
AND LEGALITY, WHERE
CUT-RATE PRICES
CONCEAL CUT-RATE
SERVICE. HEWLETT-
PACKARD HELPS US SHED
SOME LIGHT ON THE
NEFARIOUS GOINGS ON.

FRANK LENK

Many computer shoppers may have heard of the <whisper> "gray market", without ever really understanding what it is. Obviously, the term is meant to suggest something similar to the *black* market, but not quite so darkly villainous. This is true, but not particularly... er, *enlightening*.

In fact, the gray market implies trade in computer hardware (or any other articles, for that matter) outside of the normal distribution channels set up by the manufacturer. The incentive for purchasers is simple: cheaper prices. Gray-market peripherals, for example, can be hundreds of dollars cheaper than their "legitimate" counterparts. Many cost-conscious buyers may have purchased numerous items via the gray market, without even having realized it.

So what's *wrong* with the gray market? Oddly enough, quite a bit. Although gray-market shopping may seem like a bit of a free ride, buyers should bear in mind (Robert Heinlein's) wise old adage, "their ain't no such thing as a free lunch." Gray-market items may look and feel just like those that came down through the approved channels, but they may nevertheless contain more than you bargained for.

Shady Dealings

One of the hottest items on the gray market is the ubiquitous Hewlett-Packard LaserJet laser printer. Not coincidentally, Hewlett-Packard is one company that has consciously chosen to take a leading role in fight against gray marketing. A chat with Bob McDevitt, personal computer sales manager with HP Canada, revealed a lot of unexpected ramifications to what might otherwise seem a simple problem.

How does the gray market really work? Why are gray-marketers able to offer lower prices to end users? The answer is somewhat complex, but one of the clearest factors is a trade-off between cost and *support*.

A typical gray-market transaction might run somewhat as follows. A US dealer is approached by a would-be gray-marketer. The gray-marketer is immediately identifiable as such, because he will want to make a large-volume purchase, at a rock-bottom price. The dealer may be tempted to accept, in violation of his original

contract with HP. "Our contract with dealers states very clearly that they can only sell to end users," McDevitt notes. "They can't sell to resellers."

For the not-entirely scrupulous dealer, the gray-market deal is attractive in several ways. A volume sale can bring an immediate cash profit, with none of the expense of making individual sales or of supporting individual customers. Furthermore, even if the equipment is sold at little more than cost, the dealer immediately gets his overall volume up; smaller dealers who aren't yet at HP's maximum discount level may thereby be able to increase their own volume discount.

Once supplied with product, the gray-marketer then imports it into Canada. This is not overly difficult. As it happens, for example, printers are not even subject to duty. The gray-marketer's main expenses are shipping, sales tax and dollar exchange rates.

The hardware eventually ends up being retailed by Canadian dealers who are not authorized by Hewlett-Packard. This is where HP's trouble starts. "Our biggest problem with the gray market," says McDevitt, "is *support*. We don't support the product to our customers; that's what our *dealers* do." Gray-market customers often phone HP directly for support, bypassing the dealer network that the company has worked to build up.

It is exactly by skimping on intangibles such as product support that the gray marketer can undercut the legitimate dealer. "The gray marketer works on a very low margin — as low as five percent," notes McDevitt. A legitimate dealer, on the other hand, makes a markup of about 15 to 25 percent. This latter percentage is by no means pure profit; this legitimate margin helps maintain a sales staff, training, customer support, and other expenses not incurred by a more fly-by-night operator.

Ultimately, the bottom-line gain for the gray-market buyer is not as great as one might think. McDevitt ran through a typical calculation for us. An HP LaserJet currently lists for \$3725. Actual retail selling prices might typically be \$2595 to \$2795; the corresponding gray-market price would run about \$2299 to \$2599. (In a gray-market purchase, even these amounts are suspect; for example,

THE GRAY MARKET

the very lowest gray-market prices are usually quoted *sans* toner cartridge, worth \$100 to \$150, and normally included in selling price.)

Typically, therefore, customers stand to gain no more than a few hundred dollars by going to the gray market. Against this they essentially sacrifice all warranty rights, and all after-sale support to which they would otherwise be entitled.

Illegitimate Ancestry

Oddly enough, Hewlett-Packard's concern goes directly to customer satisfaction. "Our largest problem," says McDevitt, "is the dissatisfaction that the user has when he buys a product from the gray market." Gray-marketed printers may still bear the HP logo, but they don't carry the same assurance of satisfaction that is intended to come down only through HP's legitimate dealer network. Thus, while HP is not directly out-of-pocket on the gray-market deal, it sees its reputation for solid customer support being eroded.

But Hewlett-Packard is not letting the gray market go unchallenged. "In the past year we've worked to create awareness in the user community," says McDevitt. This includes advertised announcements clearly noting that products not purchased through a legitimate HP dealer will not be covered by warranty, and will not carry with them the full HP product support. "All our promotions state that."

It's important for customers to realize that the HP warranty (like most others) is valid only for the original purchaser of the equipment. In the case of gray-marketed items, that would be the original gray-market purchaser in the US.

McDevitt can recount numerous 'horror stories' of customers who have attempted to get service from shady dealers. Of course, the very reliability of the LaserJet makes it a natural gray-market item. But even the most reliable hardware will occasionally need service. Moreover, buyers of even the most reliable and user-friendly hardware may need some hand-holding. HP expects its dealers to support equipment as a *complete package* — including software they may sell along with it. The gray-market dealer is not only outside of HP's technical scrutiny, he hasn't provided himself with a

sufficient profit margin to be able to *afford* product support. Thus, while there may be exceptions, the gray-market customer is most unlikely to get the kind of quality support that Hewlett-Packard intended.

How does the customer recognize a legitimate dealer? In the case of Hewlett-Packard, the simplest way is to look for an HP sticker in the store window. Beyond this, genuine HP dealers will participate in advertised promotions — which may range from free font cartridges to \$100 rebates. There are currently some 70 authorized HP dealers across Canada, covering some 450 separate retail outlets.

Some gray-market dealers will actually claim to be authorized. Others may profess a position something like: "No, I don't believe in it; I prefer to negotiate my own price." This latter might be a valid philosophy, of course — if price were the only issue.

It is through its *logo* that HP can begin to combat the gray marketers. Dealers who use the logo illegitimately will immediately draw a letter from HP, noting that they are in violation of copyright, and warning: "desist, or be sued."

HP can also attack the gray-market directly at its roots. Serial numbers of gray-marketed hardware can often be traced to the original US dealer. Such dealers would typically get at least one or two warnings. After that, they would lose their contract to sell HP equipment. (The terms of this contract, by the way, give HP the right to come in and audit dealers' books.)

"In the last six months we've canceled a number of dealers," reports McDevitt. This has included total contracts valued at about \$35 million.

Still, one of the slipperiest things about gray marketing is that in general it violates no laws. Only if a gray-market retailer actually misrepresents himself as being authorized by HP, has he committed an offense. Of course, the original US dealer who places hardware on the gray market is at least guilty of a breach of contract.

Although HP has made considerable progress in quashing the gray market, there's a long way to go. One year ago,

"thirty to forty percent of LaserJets sold in Canada were gray market."

It is true that, in general, gray marketing may occasionally represent a free-market response to ill-considered global pricing schemes. For example, if a company has been unfairly jacking up its prices in one country while keeping them low elsewhere, gray marketers will immediately move in to make a killing based on the differential.

McDevitt admits, HP has had some work to do in this regard. However, the company has in recent years been paying very close attention to ensure that pricing is in fact rationalized between Canada and the US. Fluctuations in dollar values, for example, are now monitored on a short-term basis.

Inevitable Discrepancy

And yet, gray marketing is routinely carried on in the absence of any artificial price differentials. The usual sacrifice is on support. At least one other major microcomputer manufacturer, for example, has noted that it offers a longer warranty in Canada than in the US. This creates an obvious opportunity for gray marketers.

Such discrepancies are inevitable, in a global economy, just as it is inevitable that there will be individuals who will attempt to exploit them. HP believes that educating the consumer is the best answer.

Let the buyer beware!

CN

