Shades of grey

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Grey market. Secondary market. Parallel market. Black market.

It can be pretty confusing. What do these mean and what is the difference? And what is the impact to the watch industry in general, to brands, to retailers, to final customers?

There are many different definitions of these terms. The secondary (often also called the parallel market, but sometimes parallel also refers to the black market) is when a brand sells discontinued or older products into distribution methods other than authorized retailers (discounters, outlets, etc.) – this is done above board, without any attempt to hide where the watches are coming from. The grey market is when watches end up in other markets without the acknowledged authorization (from brands, retailers or independent distributors).

"The primary market is when you buy from authorized retailers," explains Maurice Goldberger, owner of Chiron, Inc., a company that finds alternative distribution channels for discontinued goods. "The secondary market is not novelties, but goods that have been discontinued, and it depends here on what channel you are buying it from as to whether the brand backs it or not. In the States, I demand a letter from the brand authorizing my customers to sell the merchandise. There are some retailers, like Costco, who don't care whether they are authorized."

The black market is illegal trading in goods to avoid customs duties, taxes and more. Counterfeit watches are traded on the black market, as they are by definition illegal, while branded watches are traded legally on the primary, secondary or grey markets.

These alternative markets are hard to define and quantify, as no one really wants to talk about watchmaking's 'market behind the market'. In fact, all the watch industry sources interviewed for this story requested that their names not be used. No one wants to get on the wrong side of what everyone considers a huge problem.

The issue

The issue is an elemental one – watch manufacturers, distributors and retailers all, at the end of the day, have to make money. That means that they have to sell watches.

If a certain model of a watch doesn't sell in one distribution channel, no one can expect a brand, a distributor or a retailer to just take a loss. A solution has to be found, and that often means that a watch ends up in an alternate distribution channel at a significant discount.

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Here's a concrete example: Brand X has a new model, the Alpha watch, that the management is sure will be a hit, so 10,000 units are produced at 1,000 CHF each, wholesale. At BaselWorld, distributors and retailers are unimpressed with the Alpha and orders only amount to 3,000 pieces, leaving Brand X with 7,000 pieces in stock. In order to recoup its money, Brand X has no choice but to discount the 7,000 Alphas, selling them into alternative channels at 500 CHF wholesale. Now, there are watches in retailers' shops priced at keystone, or 2,000 CHF, while a boatload of Alphas are in the market at significantly less, let's say 750 CHF, which is lower than the wholesale price the retailers paid.

How can retailers move the product they have, when savvy customers know how much the Alpha costs in other distribution channels. Retailers can discount the Alpha, but they cannot even come close to the market price set by the brand discounting, as they would be selling at a loss, which they sometimes do to recuperate some money.

The Alpha is a model that dies, but its legacy lives on as retailers resent the brand for letting the model get into alternative, competing distribution channels. The brand resents the retailers for not fully supporting the Alpha. Consumers question the value of the brand in general, when they see the Alpha in authorized retailers at 2,000 CHF and on-line or at an unauthorized retailer at 750 CHF. If this happens too often, the brand loses all credibility throughout its distribution channel and it could be the beginning of the end.

Now, let's look at another situation, without the negative impact.

Let's say Brand Y introduces the Beta watch. For the first year, Brand Y only sells the Beta into its authorized distribution. The Beta does reasonably well, but after a year, there is still stock held by the brand and its retailers. Brand Y decides to discontinue the Beta, gives its retail distribution a certain amount of time to liquidate what they have, and then proceeds to sell its remaining stock into an alternative channel at a discount. Brand Y is protecting its brand equity by not confusing the consumer and is protecting its retailers for a period of time, giving them time to sell the Beta. Then, it cuts its losses and sells to an alternate channel.

Retailers may still complain about Scenario B, saying that it's not really fair. Brand Y did all it could to see that the retailers succeeded, giving them every chance to sell the Beta. When

it was clear that the Beta would not sell through completely, Brand Y cut its losses and went to the alternative channels.

This second scenario is similar to what is the accepted practice in fashion – aged goods and last year's styles are often discounted and no one gives it a second thought. Consumers know they are buying clothing that is not in the current collection and they don't question the brand's image or quality. Now, watches are designed to be more timeless than clothing with a lifecycle that is typically quite a bit longer, but companies could approach secondary distribution like clothing.

Why do it?

With so many negatives resulting from selling into unauthorized channels, why does a brand do it? On the one hand, they talk about protecting their brand equity, yet at the same time they are damaging that image by selling current watches at heavily discounted prices.

Why does the grey market exist?

Money. Simple as that. Companies have to show a profit to their shareholders, investors or owners, so they will do almost anything to make sales. Brands are not alone in this, as retailers have to pay their bills, pay their employees and show a profit as well.

If it's a choice between showing a profit or taking a loss, the decision for the majority of companies is an easy one – take the money and run.

Where the watches come from:

This is where things get a little dicey, because the watches can end up in unauthorized channels in a number of ways.

Brands: brands can put watches into the secondary and grey markets themselves, either as close-outs of aged goods that their retail distribution cannot sell, or sometimes current watches can be sold into alternative distribution because someone made a mistake, forecasting more than the market was willing to absorb.

"This is the reality of the business, the volume brands produce with the biggest margin they can, then when they introduce the new product, they put the former inventory in the parallel world," says one small Swiss brand manager. "For brands, it's really difficult to manage when you have the same item in the same market with two different prices. The service in an authorized retailer is not enough to justify the difference in price."

"The web is becoming huge when it comes to watches and the biggest problem is price," says one medium-sized Swiss brand president. "People almost don't pay list price anymore – they know what they want and they find the best price. It is starting to get out of control and it can put your brand into jeopardy. Everyone is trying to get control of this, but it's really difficult."

Distribution: Distributors put watches into alternate channels, with or without the brand's knowledge. Sometimes a brand knows it has to 'dump' (the acknowledged term for selling products at a significant discount to get rid of them) product, so it will ask a distributor to take care of the problem for them. Other times, a distributor has to make its numbers and sells watches any way it can.

Retailers: retailers who can't sell their inventory and can't get the brand/distributor to stock balance or take product back will sometimes move product any way they can, and that often means selling to other, unauthorized retailers, to secondary market distributors or directly to 'off the beaten track' retail chains.

One brand representative remembers seeing pawn shops in Macau buying watches directly from a high-end brand at pennies on the retail price. The watches were in brand new packaging and from the current collection, as well.

"There are a couple of different factors and a couple of different ways the product gets into the grey market," says one North American brand president who preferred not to be named. "You can have a manufacturer that, for whatever reason, decides to sell directly into the secondary market, to somebody in a country that does not have any authorized distribution for the brand. If it starts that way, those watches will be traded between the manufacturer and the purchasing agent and the end consumer or unauthorized retailers. This is usually at a really steep discount, because the manufacturer has the greatest gap between the selling price and the public price. If that product ends up being sold directly to the end consumer it could be 50 per cent below retail.

"Product can also get to the secondary market from a distributor or a subsidiary, who sells directly to an unauthorized retailer," he continues. "Watches can also get into the secondary market from retailers who can't move it. It all depends on how the product has travelled to determine who is responsible. If a manufacturer has produced product and decides to sell it directly into the grey market, it's their fault. If a distributor is forced to buy back old goods and replace it with new goods,

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it's the retailer's responsibility. The retailer has transferred the problem back to the manufacturer, and I think retailers should take responsibility for what they buy."

Transshipping: Transshipping is when watches that are sold into one market, say the United States, end up in another country, like China. This often happens when demand isn't present in the first market but is in the second market. Fluctuating currency rates and varying prices from market to market can make transshipping attractive and lucrative.

Watches are the perfect product for transshipping – they are small and easy to handle. Unlike cars, which are large and difficult to conceal, watches can get into a country illegally in a number of ways.

"Retailers are doing it, brands are doing it, all via the back door as well as distributors," admits one mid-size Swiss brand president.

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"Some brands want to be at the high-end and if they don't sell, they open the back door themselves. It's like a double edged sword – you have to make your budget, but you can harm the brand name. The brands that have it under control are Patek Philippe, Rolex and some of the Richemont brands. There are some brands that don't care, they just want to sell product. The watches become a commodity. If a brand is hard to get and you pay almost full price, customers have more respect for the brand.

"When the crisis hit the US market, retailers had stock and no one was buying it," he continues. "They have to survive and pay the bills, so they start discounting, selling it at rock bottom prices. So they sell it to anyone – other retailers, distributors. The market is always where the highest demand is – like China. It's always switching. It used to go to America, but now it's going to China."

Legal or illegal?

Selling watches into the secondary or grey market is not illegal. Some brands have had success prosecuting unauthorized retailers that did not get the watches directly from the brands or the brands' representatives. Omega won a landmark case in the US Supreme Court targeting Costco's sales of grey market watches.

This is from Omega's press release, dated December 14, 2010:

"In a split decision, the United States Supreme Court has upheld an appeals court ruling that found Costco Wholesale Corporation had violated U. S. copyright law when it sold Omega Seamaster wristwatches well below retail price without Omega's permission.

"The practice employed by discounters and off-price retailers of buying imported luxury watches and other products from middlemen and selling them at lower prices is referred to as grey market trading.

"Omega argued successfully that it could use the copyrighted logo on its watches to block their sale. For Omega, the decision was a victory as it upholds their right to control the distribution, price and resale of its products.

"The Swatch Group and Omega commend the decision as it provides a legal mechanism to help control the spread of grey market trading. According to an analysis conducted by Deloitte LLP for Bloomberg in 2009, the (overall, not just watches) *grey market costs manufacturers as much as US$63 billion per year."*

Who is to blame?

First and foremost, it starts with the brand. Everyone makes mistakes, so the brands have to at least get the benefit of the doubt. However, when a brand doesn't believe in its products, how can it expect anyone else to believe in them either?

Brands should be quite cautious about forcing product on their retailers. If a retailer doesn't want to buy a watch, thinking it won't sell, it doesn't help if a brand requires the purchase of base collections in order for the retailer to get special pieces.

Distributors and retailers are not blameless, however, because often they give up on a product too easily, going for the easy sell instead of investing time and energy into determining whether a watch can be a success.

No one is entirely at fault here, nor is anyone entirely blameless.

"Selling to unauthorized channels can literally destroy a brand from the inside out," says the North American brand president. "You need to have a viable marketplace in order for secondary or grey market to exist. Once that exists, when you offer that same product for less money, people will buy it. When you offer enough of that product at a reduced price, the consumer starts to think your brand is not of value. The savvy shopper will no longer pay retail for the product, which will impact the level of distribution. Once the consumer knows he can buy the product at wholesale, you cut off the possibility for the retailer to have any kind of margin that makes sense. The retailer was the one who established the

product at the highest margin, so now that the retailer is no longer in the equation, it's a race to the bottom."

One of the reasons so many brands are verticalizing their businesses and opening brand boutiques is so they can control the distribution of their product as well. Louis Vuitton, for example, has no grey market problem, because they only sell through their own stores. There is no one to put their watches into the grey market.

Retailers have to be reasonable about their expectations — they can't demand that brands take back everything that doesn't sell, without knowing that it might end up at an unauthorized competitor.

What can be done?

Communication and true partnership is the only way that brands, distributors and retailers can get a handle on the grey market problem.

"Retailers need to be partners in the sense that they accept responsibility for the things that don't work," says the North American brand president. "Retailers should, when they can't sell the product anymore, run a sample sale. This way, they clean up their aged inventory themselves, or they can move it into their vintage department. Most of the watch companies don't want their goods back. If you are a watch company, your only customer is the retailer. If a retailer wants you to take something back that is two years old, it's unlikely you will be able to find a home for the product. Retailers need to do their best to share part of this challenge."

Brands are lowering margins in order to discourage discounting and transshipping. "The margins used to be 50%, keystone, but now it's more often in the 30s," says the mid-size Swiss brand president. The brands hope that since the margin is lower, retailers will have less room to discount, in their stores or when selling to alternative markets. Brands mystery shop their retailers and try to get 25 per cent discount, then if they get it, they send a warning letter, telling the retailer this size discount is not allowed. With a second warning, they cut the margin. If it happens a third time, they take away the brand.

"On the one side, retailers complain about grey markets, but on the other side, they are causing it by selling watches into the grey market," he continues. "They all try to have the same income or more than last year. Brands are at fault because they force retailers to buy a certain amount of merchandise. Brands tell you how much you have to order and if you don't take it, you will lose the brand."

Brands have to speak honestly with their retailers, not requiring them to take product they don't want, but at the same time asking for their help with certain models. Retailers have to be reasonable about their expectations – they can't demand that brands take back everything that doesn't sell, without knowing that it might end up at an unauthorized competitor and cause additional problems for them down the line.

Right now, the secondary and grey markets aren't talked about, but bringing them into the light for honest and open discussion might just change those shades of grey into white and the problem could be much smaller. ❮

ONE ON ONE WITH MAURICE GOLDBERGER, THE AUTHORIZED LIQUIDATOR

Maurice Goldberger owns Chiron Inc., which specializes in liquidating old stock in non-competing channels. Here's what he had to say:

"In the excess inventory business, there are problems for everyone. The brand, the owner of the name, always is concerned where the goods will be sold, what channel. From the retailers point of view, they have two issues, are these goods counterfeit and, if they are not counterfeit, are these goods backed by the brand? If you buy a Louis Vuitton bag on the corner in Wall Street and a seam tears, you take it back and the brand says, 'this isn't mine.' When you buy a Rolex watch from Costco, Rolex won't warranty the watch, but Costco will offer their own warranty. This is grey market.

"It's logical and normal that a brand needs to sell the products they can't move. Often they sell into the secondary market in a way that will protect their brand. The brand has to protect its exclusivity by selling into a secondary market where the goods are not normally represented.

"Sometimes brands push product into their retail distributorship, more than the retailers can sell, then these retailers sell into the grey market – some outside the country, etc. when people are desperate for cash, that's what happens.

"What can retailers do? Retailers can grow up. I had a case in Europe, where I bought two million Swiss francs of watches. It was sold in four countries in Europe. One of the distributors in one of the countries complained about the sales in the country, but they didn't do their part to sell the watches.

"Smart retailers should support the brands' efforts to move the goods that they can't sell. They might want the brands to keep all the goods they have ever made and protect their market, but it will hurt the manufacture in the end. Remember, the watches that are on the secondary market are not the current range, so it should not cannibalize the sales. The brands have to survive. In an ideal world, all the watches sell out or they take all the unsold goods back, dismantle them and eat the goods. That doesn't happen. Everyone has discount stores and there is a place for the current range and for last year's range. The best defence for a regular retailer is to make sure that when the customer comes in the door, he knows that he is in an authorized retailer that is selling the current range.

"The retailer needs to understand that the consumer coming into his store wants to be served in the best sense of the word. They are not looking for bargains, they are looking for the current goods. The value for the primary retailer is service. That's why people go to a five star hotel versus a three star hotel. The internet will never take that away."