

Luxury Pricing

Heiko Haasler, Marketing Director at De La Rue – Brand Protection, examines the trade-off between restrictive distribution/price disparities and parallel trade in the luxury goods market.

Imagine a designer handbag sold to a distributor in the UK for £200. This handbag is also exported to South America at a reduced price of £100. What is the effect, then, on the pricing and the brand image if a quantity of the handbags reappear in the UK at an unauthorised retailer for a price of £180? Who wins, who loses out and what future does parallel importing have?

Our imaginary handbag was, to look at the scenario in more depth, sold to a dealer in Brazil for £100 but the bags never actually arrived in the country, being diverted by the dealer who had sold the stock on to a North American company for £150 each. The North American company redirects the stock back to the UK and sells to a distributor (one not authorised to stock the item by the brand owner) for £160. The distributor sells the bags to a retailer for £170 who sells to consumers at £180 each. Initially it seems as though everyone has made a profit and the consumer has managed to purchase a £200 item at a £20 discount – unless you revisit the brand owner's situation and look at the overall long-term effect this would have on image, share price and the bottom line.

Why restrictive distribution?

Although the luxury goods market is renowned for commanding lucrative margins, there are valid reasons for this. The innovation processes, the creativity, and long development stages some items go through has to bring a return on the initial investment to allow the creative process to continue. It can be said that some of the predominant factors of a 'luxury' brand are its very exclusivity, uniqueness and novelty value.

In order to create an image of exclusivity, restrictive distribution is the strategy of limiting the number of retailers of a product. Because consumers can only buy the item in a certain store in a certain city, it engenders a perception of exclusivity due to the very fact that it is not readily available to all consumers.

Why do price disparities occur?

In the year 2000 the Consumers' Association (CA) undertook a full price survey comparing the cost of nine of the most popular Christmas presents in three US cities and nine European (including London). The results showed that eight of the items were more expensive in London – on average 19% more expensive. This study perhaps helps to reinforce recent ideas in the media of a 'rip-off Britain' ... or does it?

In a recent Department of Trade and Industry (DTI) international price comparison exercise, 133 items across Europe and the US were considered and found to be more expensive in Europe than in the US. Do such studies really take into account all the factors involved in making up a retail price?

'Price' is by no means a simple concept but is made up of a wide range of variables, such as:

- ~~///~~ Cost of production
- ~~///~~ Overheads
- ~~///~~ Taxation – direct and indirect
- ~~///~~ Level of demand
- ~~///~~ Import duties
- ~~///~~ Legislation
- ~~///~~ Exchange rates
- ~~///~~ Economic and market situation
- ~~///~~ Competition
- ~~///~~ Promotion and pricing structures

The CA blames high UK and European prices on the Trade Mark Directive legislation, which it feels gives brand owners too much control and prevents supermarkets and other retailers offering the goods at cheaper prices. The Directive allows brand owners to:

- ~~///~~ control the price of their goods
- ~~///~~ decide who is allowed to sell their goods

~~///~~ stop traders buying their goods from outside the EU.

But what effect does parallel trading have on these issues?

The effects of parallel trading

The Department of Trade and Industry's definition of parallel imports (aka grey marketing or diversion) is:

“ ... goods which have been marketed for the first time by the rights owner, or with his consent, outside the EC and are then imported into the Community.”

Although the British Brands Group (BBG) supports the free movement of goods between markets that are harmonised, it also maintains that trade mark owners have the right to withhold consent for their goods to be imported into the European Economic Area where doing so may damage the brand's reputation, increase the potential for the circulation of counterfeit goods, undermine legitimate selective distribution agreements, or damage the competitiveness of UK manufacturing.

Diversion is a global problem with the value of grey market products sold throughout the world topping a billion dollars annually (Myers and Griffith, 'Strategies for Combating Gray Market Activity' November-December 1999).

Brands in the luxury, fashion and lifestyle sectors are selling a dream based on very solid, commercial foundations of design, product quality, packaging, pricing and the right communication channels. Enormous sums of money are involved in building that 'dream' image and creating the desired consumer perception using tools such as selective distribution, sales promotion, public relations and advertising. The annual Interbrand survey calculates that for some organisations, the value of their brand accounts for 60% of the company's total worth.

For certain brands, the price and the place in which they are retailed are as essential to defining its personality as are promotion and packaging. Global distribution and outsourcing offer huge benefits to brand owners but also present opportunities for products to leak out of the supply chain and appear on the grey market, alienating legitimate retailers and leaving a company's global pricing strategy in tatters.

Designer clothing is actually a negligible proportion of the total clothing market sector. The high price of designer items has no real effect on the aggregate market prices for clothing generally. Yet the designer clothing industry can be extremely profitable because of the section of society targeted – people who are paying for the fact that they will have a unique item or have the item before anyone else, and would not purchase that same item if it was generally available to all.

If the handbag manufacturer in this scenario has to continually reduce pricing to allow authorised, domestic distributors to compete with parallel imports, the brand owner's margin is reduced and consumer perception of the now more widely available item can be severely affected. Thus, the long term image of the brand is compromised as well as the manufacturer's bottom line, and future investment in innovation could be damaged.

Such a situation does perhaps illustrate that there **is** a market for exclusivity, and price reduction of items in such a market could actually undermine consumer perception of the whole brand offering.

Is the consumer the winner?

Former Secretary of State for Trade & Industry, Stephen Byers, believed that changing European trade mark laws and relaxing rules on grey marketing would be the only way to increase competition and lower prices for consumers. It is rumoured that the campaign has not completely died and may actually be resumed in the near future. The CA is definitely on the side of the Government in this case, fighting for cheaper priced goods, as is the Parallel Traders Association (PTA) which was established in 1998 and has over 20 members, including Tesco. The PTA is committed to securing an amendment to the EU Trade Mark Directive to enable parallel trade from markets outside the EEC to take place.

But do parallel imports really benefit the consumer? According to an AIM Paper - *What price parallel trade? The real cost for Europe* – published in 1999, parallel trade does not, for the most part, lead to a significant advantage to consumers (although it does lead to a reduction in manufacturers' profits of up to 35%). In terms of customer service there may be occasions of dissatisfaction post-purchase when a consumer realises that there is no warranty, guarantee or after sales service because they

purchased from an unauthorised retailer. The product may not work as designed or may prove faulty or perhaps just unsuitable – but the consumer may not be able to exchange as the manufacturer/brand owner may have no proof of the sale to that retailer. This situation will undoubtedly damage the consumer's perception of the brand as a whole.

Another area for concern is that of consumer safety. Reports of branded electronic goods that have had expensive components removed and replaced with cheaper alternatives (the expensive parts then sold separately) are not uncommon today. Taking computer hardware as an example, consumers could believe they are buying a genuine branded item, if somewhat cheaper, on the grey market but may actually be sold potentially dangerous goods due to modifications not conforming to the branded goods' normal safety standards. The situation in this industry has become such a problem that manufacturers such as Compaq Computers, Apple and Nortel Networks in the USA have set up an organisation - The Anti-Gray Market Alliance (AGMA) - to share knowledge and resources in an effort to curtail such activity which is devaluing their brands and alienating their customers.

Are luxury goods brand owners following this model and setting up similar associations in their market places? It is possibly something they should consider.

Preventative measures

Let's return to our imaginary designer handbag for a moment and look at what measures could have been implemented to prevent parallel trading, preserve restrictive distribution and prevent damage to the overall brand image.

Track and trace solutions are now being used to address such problems and one such system combines electronic tagging of products with a secure database, through which brand owners can locate their products across the globe without leaving their office. It operates at item level, giving the option of being able to scan a single item, crated up, palletted and still inside the container. If any of the items shouldn't be there, the system immediately sets off an alert.

Each item within the client's supply chain is tagged (covertly or overtly) with a unique identifier. This "licence plate" data identifier may be carried on any machine-readable tag, such as a barcode, via microchip technology into a remote frequency

identification device (RFID). Once tagged, each item can be scanned and checked at various points in the supply chain and in the field. Items turning up at unauthorised dealers can then be tracked back to the source of the leak - and the infringer removed from the supply chain, effectively plugging the leak before brand image, relationships and profits sustain lasting damage.

If the handbag in this scenario had been covertly tagged and traced using this particular system, the brand owner would have known immediately the goods were diverted from their initial route to market. Some brand owners, such as Calvin Klein, even use overt solutions – an authenticating holographic security device with the ability to carry concealed, covert verification and tracking features. As an added benefit, the secure hologram itself has a strong visual character, which actually enhances the aesthetics of the packaging design and is extremely difficult for counterfeiters to copy.

A considerable amount of investigation needs to take place, in a discreet manner, to discover any weaknesses in the supply chain before plans can be developed and actions taken to prevent future leakages. A full consultancy service is often a good investment – one that looks at all aspects of the supply chain before recommending measures appropriate for the particular brand owner, as not every product or every brand necessitates the same solution.

Restrictive distribution and the existence of price disparities could be said to fuel the market for parallel imports. But if luxury goods brand owners were forced into allowing their goods to be sold by anyone, anywhere, the goods could become less sought after, less unique, less exclusive ... so would the market (parallel or otherwise) still be there for such goods?

So it's not just about lower prices, there's a whole economy out there that depends on brand owners and their continual innovations - and the majority of brand owners would like to be able to establish their own pricing, their own distribution networks and develop their own brand image.

Case Studies – Examples of the damage done through parallel trading

Brands are both incredibly potent and very fragile and that fragility is exposed when the brand's image is mismanaged. The following examples give some insight into the damages brand owners can suffer due to parallel imports:

1. A whisky producer's sales in the UK exceeded its distribution yet it had no idea of the origin of the additional stock, resulting in the company's global pricing strategy being undermined. The ensuing investigations in order to find out the source of the diversion were extremely costly and time consuming.

2. A luxury goods manufacturer that based its marketing strategy on the exclusivity of its product found that unauthorised distributors were flooding the market. In one case an authorised retailer in Hong Kong found that a 'cut-price' shop next door was not only selling the product at a lower price but was receiving new lines before they did! The brand's exclusive image was quite severely damaged and relationships with authorised retailers took a great deal of hard work to rebuild.

3. A US industrial manufacturer noticed sales numbers were static in one particular market, when actually sales should have been increasing. There was supposed to be only one authorised distributor of the system in the market concerned so they sent out an engineer to investigate. Within a week the engineer was able to purchase four identical units, all manufactured by the company in question, but each from a different distributor. To make matters even worse, the three items bought from unauthorised dealers were cheaper than that from the authorised one! But the unauthorised dealer was unable to offer the warranty and service back up from the manufacturer, not having been authorised to sell the units in the first place.