11 Pricing Decisions

LEARNING OBJECTIVES

11-1 Review the basic pricing concepts that underlie a successful global marketing pricing strategy.

11-2 Identify the different pricing strategies and objectives that influence decisions about pricing products in global markets.

11-3 Summarize the various Incoterms that affect the final price of a product.

11-4 List some of the environmental influences that impact prices.

11-5 Apply the ethnocentric/polycentric/geocentric framework to decisions regarding price.

11-6 Explain some of the tactics global companies can use to combat the problem of gray market goods.

11-7 Assess the impact of dumping on prices in global markets.

11-8 Compare and contrast the different types of price fixing.

11-9 Explain the concept of transfer pricing.

11-10 Define *countertrade* and explain the various forms it can take.

CASE 11-1
Global Automakers Target Low-Income Consumers

In the 1950s and 1960s, the "space race" pitted the Soviet Union against the United States in an effort to explore outer space. Half a century later, the International Space Station is a collaborative effort involving Russia, the United States, and other nations. Meanwhile, a new "race" is under way—one that is much more "down to earth" and does not involve superpowers in different hemispheres jostling for geopolitical advantage. Rather, this twenty-first-century competition involves efforts by leading automakers in Asia, Europe, and the United States to create inexpensive cars that can be sold in huge volumes to consumers in India and other developing countries.

Renault, the French automotive group, was a pioneer in the low-price segment, with its Logan model; since it was first launched in 2004, more than 4 million units have been sold (see Exhibit 11-1). Initially, the Logan was produced at a single plant operated by Renault's Dacia affiliate in Romania. As Dacia chairman Luc-Alexandre Ménard explained, "At the time, we weren't too sure of what we would do with this car. It was meant to be a one-off, a Trojan horse to penetrate new markets in developing countries." Today, Logans are manufactured in several locations, including Iran, India, and Brazil; the cars are available for sale in dozens of countries.

Two other automakers have joined the race to bring low-cost cars to the emerging-market masses. In 2009, India's Tata Motors launched the Nano, a radical new design with a rock-bottom sticker price

Exhibit 11-1 The Dacia Logan is one element at the center of Renault chief Carlos Ghosn's low-price strategy. Some entry-level models don't have power steering or air conditioning; even so, the Logan brand has proved very popular in both emerging and developed countries. The Logan's success demonstrates a very simple marketing idea: Price sells cars. Many first-time buyers have discovered that they can own a new Logan for about the same price as a motorcycle.
Source: Grzegorz Czapski/Shutterstock.

of 1 lakh (equivalent to 100,000 rupees, or $2,500). The Nano has a rear-mounted, 2-cylinder engine that delivers 33 horsepower. The top speed is 60 miles per hour, and it delivers 50 miles per gallon of gas. Nissan revived the venerable Datsun nameplate in 2014 with the launch of the $6,400 Go hatchback. Like the Nano, the new Datsun's powertrain features a 2-cylinder engine mated to a manual transmission. Unlike the Nano, which has no air bags, Datsuns are available with a driver's-side air bag. Although sales have yet to meet expectations, the social media response to the relaunched Datsun in India has been overwhelmingly positive: On Facebook, @datsunindia has more than half a million "likes" and followers.

In general, two basic factors determine the boundaries within which prices should be set. The first is product cost, which establishes a *price floor*, or minimum price. Although pricing a product below the cost boundary is certainly possible, few firms can afford to pursue this tactic over the long run. Moreover, as we saw in Chapter 8, low prices in export markets can invite dumping investigations.

Second, prices for comparable substitute products create a *price ceiling*, or maximum price. In many instances, global competition puts pressure on the pricing policies and related cost structures of domestic companies. The imperative to cut costs—especially fixed costs—is one of the reasons for the growth of outsourcing. In some cases, local market conditions, such as low incomes, force companies to innovate by creating new products that can be profitably sold at low prices. For more on the auto industry's efforts to create low-cost cars, turn to the continuation of Case 11-1 at the end of the chapter.

Between the lower and upper boundaries for every product is an *optimum price*, which is a function of the demand for the product as determined by the willingness and ability of customers to buy it. In this chapter, we will first review basic pricing concepts and then discuss several pricing topics that pertain to global marketing. These include target costing, price escalation, and environmental considerations such as currency fluctuations and inflation. In the second half of the chapter, we will discuss gray market goods, dumping, price fixing, transfer pricing, and countertrade.

11-1 Basic Pricing Concepts

◀ **11-1** Review the basic pricing concepts that underlie a successful global marketing pricing strategy.

Generally speaking, international trade results in lower prices for goods. Lower prices, in turn, help keep a country's rate of inflation in check. In a truly global market, the **law of one price** would prevail: All customers in the market could get the best product available for the best price. As Lowell Bryan and his collaborators note in *Race for the World*, a global market exists for certain products, such as crude oil, commercial aircraft, diamonds, and integrated circuits. All other things being equal, a Boeing 787 costs the same worldwide. By contrast, many consumer products made available around the world are actually offered in markets that are national rather than global in nature; that is, national competition in these markets reflects differences in factors such as costs, regulations, and the intensity of the rivalry among industry members.[1]

The beer market, for one, is extremely fragmented; even though Budweiser is the leading global brand, it commands less than 4 percent of the total market. The nature of the beer market explains why a six-pack of a global brand like Heineken varies in price by as much as 50 percent (adjusted for purchasing power parity, transportation, and other transaction costs) depending on where it is sold. In Japan, for example, the price is a function of the competition between Heineken, other imports, and four major national producers—Asahi, Kirin, Sapporo, and Suntory—which collectively command more than 90 percent of the market.

Because of these differences in national markets, the global marketer must develop pricing systems and pricing policies that take into account price floors, price ceilings, and optimum prices. A firm's pricing system and policies must also be consistent with other uniquely global opportunities and constraints. Many companies that are active in the 19 nations of the euro zone have adjusted to the new cross-border transparency of prices. Similarly, the Internet has made price information for many products available around the globe. Companies must carefully consider how customers in one country or region will react if they discover they are paying significantly higher prices for the same product than customers in other parts of the world.

Another important internal organizational consideration also exists besides cost. Within the typical corporation, there are many interest groups and, frequently, conflicting price objectives. Divisional vice presidents, regional executives, and country managers are all concerned about profitability at their respective organizational levels. Similarly, the director of global marketing seeks competitive prices in world markets. The controller and the financial vice president are concerned about profits. The manufacturing vice president seeks long production runs for maximum manufacturing efficiency. The tax manager is concerned about compliance with government transfer pricing legislation. Finally, company counsel is concerned about the antitrust implications of global pricing practices. Ultimately, the prices for a company's products generally reflect the goals set by members of the sales staff, product managers, corporate division chiefs, and/or the company's chief executive.

▶ **11-2** Identify the different pricing strategies and objectives that influence decisions about pricing products in global markets.

11-2 Global Pricing Objectives and Strategies

Whether dealing with a single home-country market or multiple country markets, marketing managers must develop pricing objectives as well as strategies for achieving those objectives. Price is always an independent variable; as a marketing tactic, managers can raise, lower, or maintain prices as part of the overall marketing strategy. Nevertheless, a number of pricing issues are unique to global marketing. The pricing strategy for a particular product may vary from country to country; a product may be positioned as a low-priced, mass-market product in some countries and as a premium-priced, niche product in others. Stella Artois beer is a case in point: As noted in Chapter 7, it is a low-priced, "everyday" beer in Belgium, but a premium brand (advertising taglines have included "Perfection Has Its Price" and "Reassuringly Expensive") in export markets. Pricing objectives may also vary depending on a product's life-cycle stage and the country-specific competitive situation. In making global pricing decisions, it is also necessary to factor in external considerations such as the added cost associated with shipping goods over long distances across national boundaries. Moreover, the issue of global pricing can be fully integrated in the product design process, an approach widely used by Japanese companies.

Market Skimming and Financial Objectives

Price can be used as a strategic variable to achieve specific financial goals, including return on investment, profit, and rapid recovery of product development costs. When meeting financial criteria such as profit and maintenance of margins is the objective, the product must be part of a superior value proposition for buyers; in such a case, price is integral to the total positioning strategy. The **market skimming** pricing strategy is often part of a deliberate attempt to reach a market segment that is willing to pay a premium price for a particular brand or for a specialized or unique product (see Exhibit 11-2 and Exhibit 11-3).

Exhibit 11-2 Reebok dominates the footwear market in India, where its cricket shoes are a top seller. Reeboks are expensive: A shoe that costs Rs2,500 requires the equivalent of a month's salary for a junior civil servant.
Source: Tsering Topgyal/Associated Press.

Companies that seek competitive advantage by pursuing differentiation strategies or positioning their products in the premium segment frequently use market skimming. For example, LVMH and other luxury goods marketers that target the global elite market segment use skimming strategies (see Case 11-3). As Muktesh Pant, the first CEO of Reebok India, noted about aspirational buyers of the company's relatively high-priced shoes, "For Rs2,000 to Rs3,000, people feel they can really make a statement. It's cheaper than buying a new watch, for instance, if you want to

Exhibit 11-3 Canada's Imax Corporation is the world's premier provider of large-format motion picture projection technology. The company has identified 900 potential markets for new Imax theaters; two-thirds of those are global. China is Imax's fastest-growing market. As of mid-2016, there were 335 Imax theaters in China, and the company's recent deal with property and media giant Dalian Wanda calls for adding 150 more screens by 2022. Imax enjoys high brand awareness levels in China's Tier 1, Tier 2, and Tier 3 cities.
Source: Zhang Peng/LightRocket via Getty Images.

make a splash at a party. And though our higher-priced shoes put us in competition with things like refrigerators and cows, the upside is that we're now being treated as a prestigious brand."

The skimming pricing strategy is also appropriate in the introductory phase of the product life cycle, when both production capacity and competition are limited. By setting a high price, demand is limited to innovators and early adopters, who are willing and able to buy and who want to be among the first to own and use the product (see Exhibit 11-2). When the product enters the growth stage of the life cycle and competition increases, manufacturers start to cut prices. This strategy has been used consistently in the consumer electronics industry. Case in point: When Sony introduced the first consumer videocassette recorders (VCRs) in the 1970s, the retail price exceeded $1,000. The same was true when compact disc players were launched in the early 1980s. Within a few years, though, prices for these products dropped well below $500. Today, of course, VCRs and CD players are obsolete, DVD players have become commodities, and streaming audio and video platforms such as Spotify and Netflix dominate their respective industries.

A similar pattern is evident with high-definition televisions (HDTVs). In late 1998, HDTVs went on sale in the United States with prices starting at approximately $7,000. This price maximized revenue on limited volume and matched demand to available supply. Subsequently, prices for HDTVs dropped significantly as consumers became more familiar with the advantages of HDTV and as next-generation factories in Asia lowered costs and increased production capacity. In 2005, Sony surprised the industry by launching a 40-inch HDTV for $3,500; by the end of 2006, comparable HDTVs were selling for approximately $2,000. Today, sets with state-of-the-art display technology cost less than $1,000, and Sony's dominance has been eclipsed by Korean brands such as LG and Samsung. The challenge facing manufacturers now is to hold the line on prices; if they do not succeed, HDTVs may also become commoditized.

Penetration Pricing and Nonfinancial Objectives

Some companies are pursuing nonfinancial objectives with their pricing strategy. In particular, price can be used as a competitive weapon to gain or maintain market position. Market share or other sales-based objectives are frequently pursued by companies that enjoy cost-leadership positions in their industry. A **market penetration pricing strategy** calls for setting price levels that are low enough to quickly build market share. Historically, many companies that used this type of pricing were located in the Pacific Rim. Scale-efficient plants and low-cost labor allowed these companies to blitz the market.

A first-time exporter is unlikely to use penetration pricing, for a simple reason: Penetration pricing often means that the product may be sold at a loss for a certain length of time. Unlike Sony, many companies that are new to exporting cannot absorb such losses, nor are they likely to have the marketing system in place (including transportation, distribution, and sales organizations) that allows global companies like Sony to make effective use of a penetration strategy.

"For us, 'Made in Italy' is so important, the quality and the artisans and the material is so important, that if we feel any kind of pressure on our profitability we will raise prices. We've found that as long as our quality is maintained the customers are willing to pay a premium."[2]

Marco Bizzari, chairman and CEO, Bottega Veneta

Companion Products: Captive ("Razors and Blades") Pricing

When formulating pricing strategies for products such as video game consoles, DVD players, and smartphones, it is necessary to view these products in a broader context. The biggest profits in the video industry come from sales of game software. In fact, Sony and Microsoft may actually lose money on each console, but the sales of hit video titles generate substantial revenues and profits that more than make up for the losses. Sony, Microsoft, and Nintendo also receive licensing fees from the companies that create the games. Moreover, typical households own only one or two consoles but dozens of games. Likewise, in the mobile phone business, substantial profits come from the services—things like apps, in-app purchases, and music downloads—that handset users purchase.

These examples illustrate the concept of *companion products*: A video game console has no value without video game software, and a DVD player has no value without movies available on DVD. Likewise, a razor handle has no value without blades. Thus, Gillette can sell a single Mach3 razor for less than $5—or even give the razor away for free—because it knows that over a period of years, the company will make significant profits from selling packages of replacement blades. As the saying goes, "If you make money on the blades, you can give away the razors."

For many years, companion products pricing has been the preferred strategy of Vodaphone, AT&T, and other cellular service providers. They buy handsets at prices set by Motorola, Nokia, and other manufacturers, and then subsidize the cost by offering significant discounts on (or even giving away) handsets to subscribers who sign long-term contracts. The carriers make up the price difference by charging additional fees for extras such as roaming, text messaging, and so on. However, this approach does not always work globally.

For example, in the United States, Apple's iPhone 5 was priced at the equivalent of $199 when combined with a 2-year phone service contract. In India and other markets, however, consumers don't like to be locked into long-term contracts. In addition, electronics imports are heavily taxed. That helps explain why the least-expensive iPhone, the SE, costs about $325, and an entry-level 16GB iPhone 6Ssells for the equivalent of $955. Moreover, Apple distributes the iPhone in India exclusively through stores operated by Airtel, an Indian carrier, and Vodaphone. Indian sales of the iPhone have been slow because consumers in that country tend to choose lower-priced models from Nokia and Samsung that are distributed through more retailers. In the product's early days, a significant number of $199 iPhone 5s made the trip from the United States to India in tourist luggage![3] Today, all the major handset manufacturers are designing lower-priced versions for emerging markets.

When Sony was developing the Walkman in the late 1970s, the company's initial plans called for a retail price of ¥50,000 ($249) to achieve break-even. Some executives, however, believed that a price of ¥35,000 ($170) was necessary to attract the all-important youth market segment. After the engineering team conceded that it could trim costs to achieve break-even volume at a price of ¥40,000, chairman Akio Morita pushed them further and insisted on a retail price of ¥33,000 ($165) to commemorate Sony's 33rd anniversary. At that price, even if the initial production run of 60,000 units sold out, the company would lose $35 per unit.

The marketing department was convinced the product would fail: Who would want a tape recorder that couldn't record? Even Yasuo Kuroki, the project manager, hedged his bets: He ordered enough parts for 60,000 units but had only 30,000 produced. Although sales were slow immediately following the Walkman's launch in July 1979, they exploded in late summer. The rest, as the saying goes, is marketing history.[4]

Target Costing[6]

Japanese companies have traditionally approached cost issues in a way that results in substantial production savings and products that are competitively priced in the global marketplace. Toyota, Sony, Olympus, and Komatsu are some of the well-known Japanese companies that use target costing. Researchers Robin Cooper and W. Bruce Chew have described this process, sometimes known as *design to cost*, as follows:

> Target costing ensures that development teams will bring profitable products to market not only with the right level of quality and functionality but also with appropriate prices for the target customer segments. It is a discipline that harmonizes the labor of disparate participants in the development effort, from designers and manufacturing engineers to market researchers and suppliers. . . . In effect, the company reasons backward from customers' needs and willingness to pay instead of following the flawed but common practice of cost-plus pricing.[7]

"Nobody buys a piece of hardware because they like hardware. They buy it to play movies or music content."[5]

Howard Stringer, former chairman, Sony Corporation

Western companies are beginning to adopt some of these money-saving ideas. Target costing was used in the development of Renault's Logan, a car that retails for less than $10,000 in Europe. Nissan also used target costing to develop a $3,000 Datsun (see Case 11-1). According to Luc-Alexandre Ménard, chief of Renault's Dacia unit, the design approach prevented technical personnel from adding features that customers did not consider absolutely necessary. For example, the first-generation Logan's side windows had relatively flat glass; curved glass is more attractive, but it adds to the cost. The Logan was originally targeted at consumers in Eastern Europe; to the company's surprise, it has proved popular in Germany and France as well.[8]

The target costing process begins with market mapping and product definition and positioning; this requires using concepts and techniques discussed in Chapter 6 and Chapter 7. The marketing team must do the following:

- Determine the segment(s) to be targeted, as well as the prices that customers in the segment will be willing to pay. Using market research techniques such as focus groups and conjoint analysis, the team seeks to better understand how customers will perceive product features and functionalities.

- Compute overall target costs with the aim of ensuring the company's future profitability.
- Allocate target costs to the product's various functions. Calculate the gap between the target cost and the estimated actual production cost. Think of debits and credits in accounting: Because the target cost is fixed, additional funds allocated to one subassembly team for improving a particular function must come from another subassembly team's funds.
- Obey the cardinal rule: If the design team can't meet the targets, the product should not be launched.

The target costing approach can be used with inexpensive consumer nondurables. In Mexico and other emerging markets, Procter & Gamble (P&G) managers know that workers are often paid a daily wage; its Mexican customers generally carry 5- and 10-peso coins. To keep prices of shampoo and detergent below, say, 11 or 12 pesos and still ensure satisfactory profit margins, P&G uses target costing (P&G calls it "reverse engineering"). Rather than create an item and then assign a price to it—the traditional cost-plus approach—the company first estimates what consumers in emerging markets can afford to pay. From there, product attributes and manufacturing processes are adjusted to meet various pricing targets. For example, to hold down the cost of its Ace Natural detergent, which is used to hand-wash clothes in Mexico, P&G reduced the product's enzyme content. The result: a product that costs a peso less than a single-use packet of regular Ace. In addition, the reformulated product is gentler on the skin.[9]

The target costing process can also go hand-in-hand with sourcing decisions. Consider the case of an Italian company that markets lifestyle and performance apparel and footwear. Manufacturing is Italy's strength, but labor costs in the country are high. In fact, the target price that consumers are willing to pay for some products is too low to allow for Italy-based production. Thanks to the Internet, consumers in all parts of the world are familiar with prices and will quickly identify price disparities. Likewise, retailers want an "equal price policy." The challenge for the Italian company is how to keep its industrial know-how without giving it away to an original equipment manufacturer (OEM) factory in, say, Romania or Slovenia.

Suppose the company is designing a new ski boot with advanced materials. When it comes to product development and R&D, the teams ask, "What does the high-end athlete need, no matter what the cost?" If product testers like the prototype, the concept is refined into a consumer product that is less radical so it can sell at the right price point.

Of course, consumers in different parts of the world have different needs. So, another challenge is to standardize as much as possible and make compromises with respect to versions destined for the United States versus the European Union versus Asia.

When all of these considerations are taken into account, the team arrives at a second design that will be accepted by consumers and be price efficient. In the ski boot example, the high-end, high-value-added version will be "Made in Italy" while the lower-priced consumer version will be "Made in Slovenia."

Calculating Prices: Cost-Plus Pricing and Export Price Escalation

Laptops, smartphones, tablets, and other popular consumer electronics products exemplify many characteristics of today's global supply chain: No matter what the brand—Acer, Apple, Dell, Samsung, or something else—components are typically sourced in several different countries, and the products themselves are assembled in China, Taiwan, or Japan. Within a matter of days, the goods are sent via air freight to the countries where they will be sold. As anyone who has studied managerial accounting knows, finished goods have a cost associated with the actual production. In global marketing, however, the total cost depends on the ultimate market destination, the mode of transport, tariffs, various fees, handling charges, and documentation costs. **Export price escalation** is the increase in the final selling price of goods traded across borders that reflects these factors. The following is a list of eight basic considerations for those whose responsibility includes setting prices on goods that cross borders:[10]

1. Does the price reflect the product's quality?
2. Is the price competitive given the local market conditions?
3. Should the firm pursue market penetration, market skimming, or some other pricing objective?
4. Which type of discount (trade, cash, quantity) and allowance (advertising, trade-off) should the firm offer its international customers?

5. Should prices differ with market segment?
6. Which pricing options are available if the firm's costs increase or decrease? Is demand in the international market elastic or inelastic?
7. Are the firm's prices likely to be viewed by the host-country government as reasonable? Exploitative?
8. Do the foreign country's dumping laws pose a problem?

Companies frequently use a method known as cost-plus or cost-based pricing when selling goods outside their home-country markets. **Cost-based pricing** is based on an analysis of internal (e.g., materials, labor, testing) and external costs. As a starting point, firms that comply with Western cost-accounting principles typically use the *full absorption cost method*; this defines the per-unit product cost as the sum of all past or current direct and indirect manufacturing and overhead costs.

Beyond this per-unit cost, when goods cross national borders, additional costs and expenses such as transportation, duties, and insurance are incurred. If the manufacturer is responsible for those costs, they, too, must be included (we discuss Incoterms in the next section). By adding the desired profit margin to the cost-plus figure, managers can arrive at a final selling price. It is important to note that in China and some other developing countries, many manufacturing enterprises are state run and state subsidized—a factor that makes it difficult to calculate accurate cost figures and opens a country's exporters to charges that they are selling products for less than the "true" cost of producing them. The recent controversy over Chinese-made solar panel exports is a case in point.

Companies using *rigid cost-plus pricing* set prices without regard to the eight considerations listed previously. They make no adjustments to reflect market conditions outside the home country. The obvious advantage of rigid cost-based pricing is its simplicity: Assuming that both internal and external cost figures are readily available, it is relatively easy to arrive at a quote. The disadvantage is that this approach ignores demand and competitive conditions in target markets; the risk is that prices will be set either too high or too low.

An alternative method, *flexible cost-plus pricing*, is used to ensure that prices are competitive in the context of the particular market environment. Experienced exporters realize that the rigid cost-plus approach can result in severe price escalation, with the unintended result that exports are priced at levels above what customers are willing or able to pay. Managers who utilize flexible cost-plus pricing are acknowledging the importance of the eight criteria listed earlier. Flexible cost-plus pricing sometimes incorporates the *estimated future cost method* to establish the future cost for all component elements. For example, the automobile industry uses palladium in catalytic converters. Because the market price of heavy metals is volatile and varies with supply and demand, component manufacturers might use the estimated future cost method to ensure that the selling price they set will enable them to cover their costs.

11-3 Incoterms

◀ **11-3** Summarize the various Incoterms that affect the final price of a product.

Every commercial transaction is based on a contract of sale, and the trade terms in that contract specify the exact point at which the ownership of merchandise is transferred from the seller to the buyer and which party in the transaction pays which costs. The following activities must be performed when goods cross international boundaries:

1. Obtaining an export license, if required (In the United States, nonstrategic goods are exported under a general license that requires no specific permit.)
2. Obtaining a currency permit, if required
3. Packing the goods for export
4. Transporting the goods to the place of departure (which usually involves transport by truck or rail to a seaport or airport)
5. Preparing a land bill of lading
6. Completing necessary customs export papers
7. Preparing customs or consular invoices as required by the country of destination
8. Arranging for ocean freight and preparation
9. Obtaining marine insurance and certificate of the policy

ENTREPRENEURIAL LEADERSHIP, CREATIVE THINKING, AND THE GLOBAL STARTUP

Dr. Dre and Jimmy Iovine, Beats Electronics and Beats Music

Dr. Dre and Jimmy Iovine are entrepreneurs. Working as a team, they started a company, created a brand, developed an innovative product, and began to manufacture and market it. By applying the basic tools and principles of modern marketing, Dre and Iovine have achieved remarkable success. Along the way, they also became billionaires! As is true with many entrepreneurs, their breakthrough idea was based on their recognition of a problem that needed to be solved. Both were music industry veterans who identified an opportunity to develop high-quality consumer headphones that would enhance the music playback experience while also serving as a fashion accessory.

Dr. Dre (real name: Andre Young) is a well-known hip-hop recording artist who got his start in the music business as a DJ while growing up in the Compton, California, projects. After bursting into the public eye with gangsta rap pioneers NWA in the late 1980s, Dre started recording solo albums. His signature sound, a bass-heavy beat, had a significant impact on the burgeoning hip-hop scene. In addition to creating his own music, Dre's resume includes starting Death Row Records and Aftermath Entertainment. As label chief, Dre helped launch the careers of Snoop Dogg, Tupac Shakur, Eminem, 50 Cent, and many other artists.

Dre identified a problem that grew out of the surging popularity of DJ culture on the music scene. He was frustrated with the low-fidelity audio that music fans experienced when they listened to music on mobile devices such as iPods and laptops. As Dre explains, "I want to hear the music like I hear it in the clubs. I want to hear the same sounds the DJ hears."

Dre's business partner, Jimmy Iovine, is a true music industry mogul. He founded Interscope Records in 1990; by 2014, after more than two decades of producing hit records and making deals, he was chairman of Interscope Geffen A&M records. Iovine was also well known to television viewers as a regular for three seasons on the popular *American Idol* talent search show.

Dre and Iovine shared a passion for sonic integrity in music playback. After disassembling the ear buds that were standard equipment with portable music players and smartphones, the duo recognized that cheap components were the root cause of the lo-fi sound. Dre and Iovine formed Beats Electronics in 2006 and set about designing a premium headphone that would deliver the sound they wanted. Although other high-end headphone brands were already on the market, they were niche products aimed at audiophiles.

In 2008, the young company introduced the Studio line of Beats by Dr. Dre on-ear headphones, priced at $299 and featuring an embossed lowercase "b" on each ear cup. The bottom line: They sounded great, and they looked great, too. Almost overnight, Beats caught on with celebrities as well as the general public. The following year, Hewlett-Packard launched the Envy line of laptops that incorporated Beats audio technology for improved sound.

By 2013, Beats by Dr. Dre had grown into a $1 billion-plus global business and had become the top-selling brand in dozens of countries (see Exhibit 11-4). Meanwhile, Dre and Iovine were turning their attention to streaming music. They acquired online music service Mog in 2012. In 2014, in conjunction with Nine Inch Nails frontman Trent Reznor, they launched Beats Music, a subscription streaming service. Why launch a new service in an industry space dominated by Pandora, Spotify, and other competitors? According to Iovine, the new service was designed to do a better job of helping music lovers decide what to listen to.

Beats Music began life as a $10-per-month subscription service that offers users access to millions of songs. A key feature is curation: In contrast to services that rely primarily on data-driven computer algorithms, Beats staffers and guest programmers—human beings with ears, in other words—assist in the creation of playlists.

Sources: *The Defiant Ones*, Directed by Allen Hughes, Netflix, 2017; Matthew Garrrahan, "Hip-Hop's First Billionaire Mixes Beats with Business," *Financial Times* (May 31/June 1, 2014), p. 7; Ben Sisario, "Algorithm for Your Personal Rhythm," *The New York Times* (January 12, 2014), pp. 1, 24; Hannah Karp, "Beats Stars Sidle up to Apple," *The Wall Street Journal* (May 10–11, 2014), p. B3.

Exhibit 11-4 Dr. Dre became the first hip-hop billionaire when Beats, the company he cofounded with Jimmy Iovine, was acquired by Apple for $3 billion.

Source: Todd Williamson/Invision/Associated Press.

Who is responsible for performing these tasks? It depends on the terms of the sale. The internationally accepted terms of trade are known as International Commercial Terms, shortened to **Incoterms**. Incoterms are classified into four categories. **Ex-works (EXW)**, the sole "E-Term" or "origin" term among Incoterms, refers to a transaction in which the buyer takes delivery at the premises of the seller; the buyer bears all risks and expenses from that point on. In principle, ex-works affords the buyer maximum control over the cost of transporting the goods. Ex-works can be contrasted with several "D-Terms" ("post-main-carriage" or "arrival" terms). For example, under **delivered duty paid (DDP)**, the seller has agreed to deliver the goods to the buyer at the place the buyer names in the country of import, with all costs, including duties, paid. Under this contract, the seller is also responsible for obtaining the import license if one is required.

Another category of Incoterms is known as "F-Terms" or "pre-main-carriage terms." Because it is suited for all modes of transport, **free carrier (FCA)** delivery is widely used in global sales. Under FCA, transfer from seller to buyer occurs when the goods are delivered to a specified carrier at a specified destination. Two additional F-terms apply to sea and inland waterway transportation only. **Free alongside ship (FAS) named port** is the Incoterm for a transaction in which the seller places the shipment alongside, or available to, the vessel upon which the goods will be transported out of the country. The seller pays all charges up to that point. The seller's legal responsibility ends once the goods have been cleared for export; the buyer pays the cost of actually loading the shipment. FAS is often used with *break bulk cargo*, which is noncontainerized, general cargo such as iron, steel, or machinery (often stowed in the hold of a vessel rather than in containers on the deck). With **free on board (FOB) named port**, the responsibility and liability of the seller do not end until the goods—typically housed in containers—have cleared the ship's rail. As a practical matter, access to the terminal and harbor areas in many modern ports may be restricted; in such an instance, FCA should be used instead.

Several Incoterms are known as "C-Terms" or "main-carriage" terms. When goods are shipped **cost, insurance, freight (CIF) named port**, the risk of loss or damage to goods is transferred to the buyer once the goods have passed the ship's rail. In this sense, CIF is similar to FOB. However, with CIF, the seller has to pay the expense of transportation for the goods up to the port of destination, including the expense of insurance. If the terms of the sale are **cost and freight (CFR)**, the seller is not responsible for risk or loss at any point outside the factory.

Table 11-1 is a typical example of the kind of export price escalation that can occur when some of these costs are added to the per-unit cost of the product itself. In this example, a Des Moines–based distributor of agricultural equipment is shipping a container load of agricultural tires to Yokohama, Japan, through the port of Seattle. A shipment of tires that costs ex-works $45,000 in Des Moines ends up with a total retail price in excess of $66,000 in Yokohama. A line-by-line analysis of this shipment shows how price escalation occurs. First, there is the total shipping charge of $2,715, which is 6 percent of the ex-works Des Moines price. The principal component of this shipping charge is a combination of land and ocean freight totaling $1,475.

All import charges are assessed against the landed price of the shipment (CIF value). Note that there is no line item for duty in this example; no duties are charged on agricultural equipment sent to Japan, although duties may be charged in other countries. A nominal distributor markup of 10 percent ($4,925.46) actually represents 12 percent of the CIF Yokohama price because it is a markup not only on the ex-works price, but also on the freight and value-added tax (VAT) as well. Finally, a dealer markup of 25 percent adds up to $12,313.64 (27 percent) of the CIF Yokohama price. Like distributor markups, dealer markup is based on the total landed cost.

The net effect of this add-on, accumulating process is a total retail price in Yokohama of $66,493.67, or 147 percent of the ex-works Des Moines price. This example of price escalation is by no means an extreme case. Indeed, longer distribution channels or channels that require a higher operating margin, as are typically found in export marketing, can contribute to dramatic price escalation. Because of the layered distribution system in Japan, the markups in Tokyo could easily result in a price that is 200 percent of the CIF value.

An example of price escalation for a single product is shown in Table 11-2. A right-hand-drive Jeep Grand Cherokee equipped with a V8 engine ends up costing ¥5 million—roughly $50,000—in Japan. The final price represents 167 percent of the U.S. sticker price of $30,000.

Price escalation was also a major issue in China. Jeep established the first joint U.S./China auto operation in 1983; however, production ceased in 2006. Until recently, the Compass, Wrangler, and Cherokee models were all shipped from the United States and were subject to a

TABLE 11-1 Price Escalation: A 20-ft Container of Agricultural Equipment Shipped from Des Moines to Yokohama*

Item			Percentage of Ex-Works Price
Ex-works Des Moines		$45,000	100%
Inland and ocean freight from DSM to CY Yokohama	$1,475.00		4.44%
Bunker adjustment fee	300.00		0.67%
Destination charges	240.00		0.53%
Freight forwarding fee	150.00		0.33%
AES filing fee	25.00		0.06%
Total shipping charges	$2,715.00	$ 2,715.00	6.03%
Insurance (110% of CIF value)—$0.20 per $100		104.97	0.23%
Total CIF Yokohama value		$47,819.97	106.27%
VAT (3% of CIF value)		1,434.60	3.19%
Landed cost		49,254.57	109.45%
Distributor markup (10%)		4,925.46	10.95%
Dealer markup (25%)		12,313.64	27.36%
Total retail price		$66,493.67	147.76%

*This was loaded at the manufacturer's door, shipped by stack train to Seattle, and then transferred via ocean freight to Yokohama. Total transit time from factory door to foreign port was about 30 days.

25 percent import tariff. In dollar terms, the sticker price of a fully loaded Jeep Grand Cherokee SRT8 with a 6.4-liter V8 engine could top $200,000—more than triple the U.S. price of $62,790! No wonder Fiat Chrysler Automobiles (FCA) opted to start local production in 2015 (see Exhibit 11- 5). FCA chief executive Sergio Marchionne has set a goal of tripling Jeep's sales in China to 500,000 units by 2018.[11]

These examples of cost-plus pricing show an approach that a beginning exporter might use to determine the CIF price. The same approach could also be used for differentiated products such as the Jeep Cherokee for which buyers are willing to pay a premium. As noted earlier, experienced global marketers are likely to take a more flexible approach and view price as a strategic variable that can help achieve marketing and business objectives (see Exhibit 11-5).[12]

From a practical point of view, a working knowledge of Incoterms can be a source of competitive advantage to anyone seeking an entry-level job in global marketing. A former export

TABLE 11-2 An American-Built Jeep Grand Cherokee Goes to Japan (estimates)

Item	Amount of Price Escalation	Total
Ex-works price	0	$30,000
Exchange rate adjustment	$2,100	$32,100
Shipping	$300	$32,400
Customs fees	$1,000	$33,400
Distributor margin	$3,700	$37,100
Inspection, accessories	$1,700	$38,800
Added options, prep	$3,000	$41,800
Final sticker price	$8,200	$50,000

Exhibit 11-5 Jeep enjoys high brand awareness in China, thanks in part to Jeep-branded clothing sold in specialty stores. Fiat Chrysler Automobile's market strategy for the brand includes restarting local production and doubling the number of dealers.
Source: Andy Wong/Associated Press.

coordinator at a U.S.-based company that markets industrial ink products, explains how terms of the sale affect price:[13]

> We actually use different Incoterms as incentives for larger orders. Instead of offering a "price break" price, we offer a better Incoterm based upon the size of a customer's order. We adhere to some general guidelines: Any order less than 1 ton is sold on an ex-works basis. Anything 1 ton or more is sold CIF port. All air freight is ex-factory. We will, of course, go to great lengths to ensure that our customers are happy. So, even though a product is sold ex-works, we'll often arrange shipping to destination port (CIF) or airport (CIP), or to the domestic port (FOB) and simply tag the freight cost onto the invoice. We end up with an ex-factory price, but a CIF or FOB invoice total. Sounds complicated, doesn't it? It keeps me busy arranging shipping.

11-4 Environmental Influences on Pricing Decisions

◀ **11-4** List some of the environmental influences that impact prices.

Global marketers must deal with a number of environmental considerations when making pricing decisions. Among them are currency fluctuations, inflation, government controls and subsidies, and competitive behavior. Some of these factors work in conjunction with others; for example, inflation may be accompanied by government controls. Each is discussed in detail in the following paragraphs.

Currency Fluctuations

In global marketing, fluctuating exchange rates complicate the task of setting prices. As we noted in Chapter 2, currency fluctuations can create significant challenges and opportunities for any company that exports. Management faces different decision situations, depending on whether currencies in key markets have strengthened or weakened relative to the home-country currency. A weakening of the home-country currency swings exchange rates in a favorable direction: A producer in a weak-currency country can choose to cut export prices to increase market share, or maintain its prices and reap healthier profit margins. Overseas sales can result in windfall revenues when translated into the home-country currency.

It is a different situation when a company's home currency strengthens; this is an unfavorable turn of events for the typical exporter because overseas revenues are reduced when translated into the home-country currency. As an example, suppose the U.S. dollar weakens relative to the Japanese yen. This is good news for American companies such as Boeing, Caterpillar, and GE, but bad news for Canon and Olympus (and Americans shopping for cameras). Indeed, according to Teruhisa Tokunaka, chief financial officer of Sony, a 1-yen shift in the yen–dollar exchange rate can raise or lower the company's annual operating profit by 8 billion yen (see Figure 11-1).[14] These examples underscore the point that "roller-coaster" or "yo-yo"–style swings in currency values, which may move in a favorable direction for several quarters and then abruptly reverse, characterize today's business environment.

The degree of exposure varies among companies. Harley-Davidson exports most of its motorcycles from the United States. In every export market, the company's pricing decisions must take currency fluctuations into account. Similarly, 100 percent of German automaker Porsche's production takes place at home; Germany serves as its export base. However, for exports within the euro zone, Porsche is insulated from currency fluctuations.

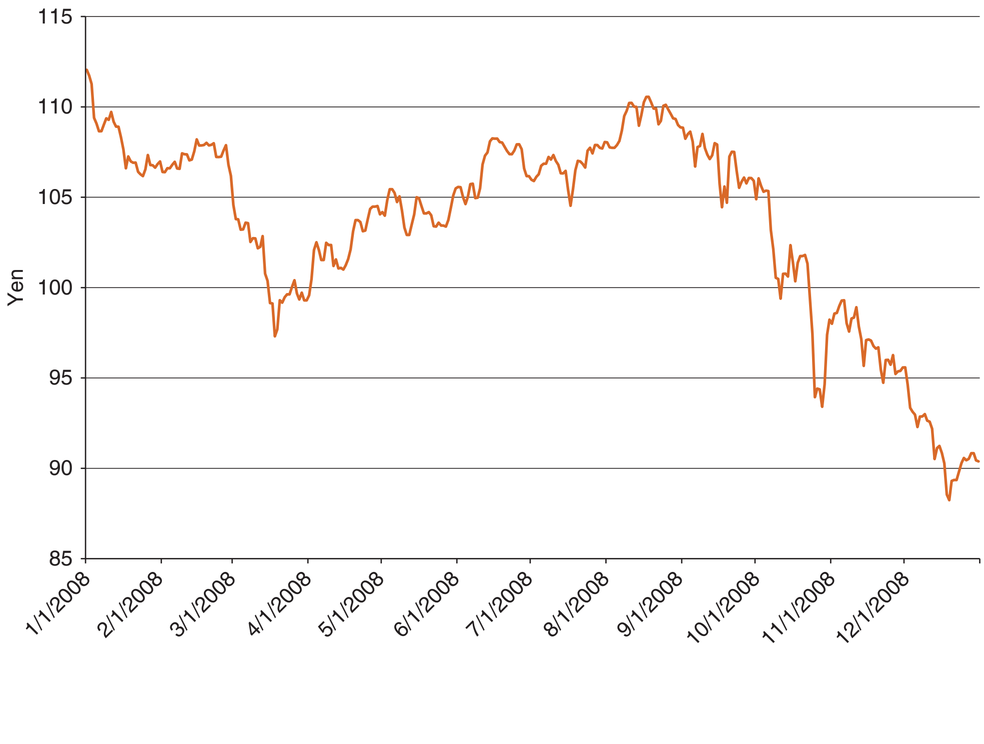
In responding to currency fluctuations, global marketers can utilize other elements of the marketing mix besides price. In some instances, slight upward price adjustments due to the strengthening of a country's currency have little effect on export performance, especially if demand is relatively inelastic. Companies in the strong-currency country can also choose to absorb the cost of maintaining international market prices at previous levels—at least for a while. Other options include offering improved quality or after-sales service, improving productivity and cutting costs, and sourcing outside the home country.[15]

Companies using the rigid cost-plus pricing method described earlier may be forced to change to a more flexible approach. The use of the flexible cost-plus method to reduce prices in response to unfavorable currency swings is an example of a **market holding strategy** and is adopted by companies that do not want to lose market share. If, by contrast, large price increases are deemed unavoidable, managers may find that their products can no longer compete.

In the 3 years immediately after the euro zone was established, the euro declined in value more than 25 percent relative to the U.S. dollar. This situation forced American companies—in particular, small exporters—to choose from among the options associated with strong currencies. The strategy selected varied according to a company's particular circumstances. For example, Vermeer Manufacturing of Pella, Iowa, a midsized company with approximately $1 billion in annual sales, prices its products in euros for the European market. As 2000 came to an end, Vermeer had been forced to raise its European prices four times since the euro's introduction. Its subsidiary in the Netherlands pays employees in euros and also buys materials locally.

FIGURE 11-1 Value of U.S. Dollars versus Japanese Yen

Source: Based on data gathered by the Board of Governors of the Federal Reserve (www.federalreserve.gov).



EMERGING MARKETS BRIEFING BOOK

Demand in Asia Drives Fine Wine Prices

As every student of microeconomics knows, when demand exceeds supply, prices tend to rise. The market for fine wine is a textbook example. Each year connoisseurs seek out wines from top estates such as France's Château Lafite Rothschild. A single bottle from a top vintage—for example, 2009—can cost $1,000 or more. The world's best wines need some time in the cellar and, as the years go by, the bottles appreciate in value.

Today, a set of new customers has joined the global wine culture: affluent collectors in China and other Asian countries (see Exhibit 11-6). Several factors have contributed to this trend. In 2008, the Hong Kong government reduced tariffs on wine imports from 40 percent to zero. Since then, a flourishing wine auction scene has emerged within the Special Administrative Region. Although mainland China still imposes ad valorem taxes on wine, hand-carried bottles crossing the border from Hong Kong are not taxed. Needless to say, this has created a business opportunity for entrepreneurial individuals to hire "mules" to transport wine to the mainland. Also not surprisingly, considering the prices consumers are paying, there is a brisk trade in counterfeit wine.

With the booming Chinese economy, well-heeled consumers and collectors in that country can't seem to get enough of Château Lafite and other wines. How many Chinese are willing and able to buy expensive wine? According to industry observers, the number is between 5,000 and 10,000. Chinese wine drinkers do their homework; they have been known to check out the tasting scores and prices of wines they have been served. This, of course, reflects the importance of status in Asian culture. Meanwhile, recession-weary buyers in Japan, the United States, and Europe are scaling back on their purchases of expensive wines. As one European wine exporter noted, "Every case of Château Lafite we purchase ends up in China."

Singapore and Indonesia are also vibrant markets for fine wine. Retail distribution in Singapore is streamlined compared to elsewhere, meaning that importers can sell directly to consumers. In addition, government regulations have been loosened somewhat, and two casinos have opened as part of the Resorts World Sentosa and Marina Bay Sands developments. Free-spending high rollers at these establishments want to drink the best. Demand for fine wine is growing in Indonesia as well, even though the hot, humid climate creates challenges for members of the wine trade hoping to keep wine in saleable condition.

Sources: Jason Chow, "French Wines Are Tough Sell," *The Wall Street Journal* (April 26, 2013), p. B1; Jancis Robinson, "China's Viticultural Revolution," *Financial Times—Life & Arts* (February 12–13, 2011), p. 4; Gideon Rachman, "China Reaps a Vintage European Crop," *Financial Times* (November 30, 2010), p. 13; Kimberly Peterson, "New Whine: China Pushes Bordeaux Prices Higher," *The Wall Street Journal* (September 15, 2010), pp. B1, B2; John Stimpfig, "Demand from China Fuels Spectacular Performance," *Financial Times Special Report: Buying and Investing in Wine* (June 19, 2010), p. 6; Robinson, "A Continent of Connoisseurs," *Financial Times* (May 15, 2010), p. 11; Laura Santini, "Wealthy Chinese Make Hong Kong a New Wine Hub," *The Wall Street Journal* (December 2, 2009), p. B9.

Exhibit 11-6 High auction prices in Hong Kong reflect skyrocketing Asian demand for top-rated French wines such as those from Château Lafite Rothschild. China is the most important export market for Bordeaux wine producers, accounting for more than one-third of that region's exports. Chinese investors are also snapping up top winemaking estates in France.
Source: Philippe Lopez/AFP/GettyImages.

By contrast, Stern Pinball of Melrose Park, Illinois, prices its machines in dollars in export markets. Company president Gary Stern's product strategy also reflects a strong-currency strategy: To offset the higher cost to European customers who must convert euros before paying in dollars, the company developed new features such as pinball machines that "speak" several European languages. It has also produced new products such as a soccer game themed to European interests as well as an Austin Powers game targeted at the United Kingdom. As Stern commented, "If I were bright enough to know which way the euro was going, I sure wouldn't be making pinball machines. I'd be trading currency."[16]

As noted earlier, price discrepancies across the euro zone have been disappearing because manufacturers are no longer be able to cite currency fluctuations as a justification for the discrepancies. **Price transparency** means that buyers are able to comparison shop easily because goods will be priced in euros as opposed to marks, francs, or lira. For several years, the European Commission published an annual report comparing automobile price differences in the European Union. Thanks in part to the Internet, price discrepancies have narrowed; in 2011, the commission discontinued the report.

"We believe that our customers—especially our European customers—are just as willing to pay in pounds and may have more access to British pounds than dollars."[17]

Christine Russell, chief financial officer, Evans Analytical Group LLC, Santa Clara, California

Even in the euro zone, some automobile prices differ in various countries due to different standards for safety equipment and different tax levels. For example, Denmark and Sweden have a VAT of 25 percent, the highest rate in the European Union. Moreover, Denmark taxes luxury goods heavily. Taxes are also high in Finland, Belgium, Ireland, Austria, and Italy. Volkswagen has already begun to harmonize its wholesale prices for vehicles distributed in Europe.

Inflationary Environment

Inflation, or a persistent upward change in price levels, is a problem in many country markets. An increase in the money supply can cause inflation; in turn, inflation is often reflected in the prices of imported goods in a country whose currency has weakened. For example, following the Brexit vote in 2016, the British pound fell approximately 15 percent against the euro and other major currencies. That was a mixed blessing for producers of English sparkling wine. On the plus side, export prices for wines made in England were more attractive and boosted demand, while the price of Champagne imported from France to the United Kingdom increased. As for the downside, most English vintners buy winemaking equipment and supplies such as bottles from Europe, so they are paying higher prices.[18]

Spiraling commodities and raw materials costs may also put upward pressure on prices for a variety of goods. These are more than just theoretical issues for businesses. Indeed, understanding the dynamics affecting price and product decisions can help recent graduates respond to tough interview questions. For example, a prospective employer might ask how you would deal with increasing commodity costs. How would you respond, if asked?

Take chocolate, for example. Mondelez International's iconic Toblerone chocolate bars are produced in Berne, Switzerland, and exported to more than 120 countries. In January 2015, production costs jumped in Switzerland due to a significant drop in the value of the euro against the Swiss franc. Cocoa prices also have risen steadily over the past several years. How did the company respond? Rather than raise prices, it reduced the size of the chocolate bar (see Exhibit 11-7). Call it "shrinkflation!"

Exhibit 11-7 Toblerone chocolate bars are available in different sizes and distributed through a variety of retail channels. The smaller bars, often sold by discounters, were recently "downsized" from 170 grams to 150 grams while the price stayed the same.
Source: Darren Staples/Reuters.

Higher prices for corn and wheat may force companies such as Kraft Foods to raise prices; as noted in Case 2-2, however, many global companies formulate and implement sophisticated commodity hedging strategies in an effort to avoid such price increases. Higher prices for copper, oil, and other commodities mean that managers at United Technologies must review pricing for the helicopters, jet engines, and air-conditioning systems the company makes. And, as anyone who shopped for clothes in the early 2010s can attest, prices for sweaters, jeans, and T-shirts increased sharply. The reason? Cotton inventories were low worldwide, and the price of cotton almost doubled.[19]

An essential requirement for pricing in an inflationary environment is the maintenance of operating profit margins. Inflation may require price adjustments for a simple reason: Rising costs must be covered by higher selling prices. Regardless of cost-accounting practices, if a company maintains its margins, it has effectively protected itself from the effects of inflation.

Sometimes inflationary forces arise out of changes in the political environment. For example, in early 2018, U.S. President Donald Trump announced tariffs of 10 percent on aluminum imports from China and several other nations. That was bad news for the beer industry; the U.S. beer market represents about $100 billion in annual sales of aluminum, much of it in the form of aluminum cans. A trade group called the Beer Institute estimated that the tariffs amount to a $347 million tax on the beverage industry by raising its variable costs.

An aluminum beer can costs about 10 cents to manufacture, so a 10 percent tariff on aluminum would boost the cost of each can by about a penny, or roughly 6 cents per six-pack. Marketing managers at AB InBev, the company that brews Bud Light, face a decision about whether they can pass on the increased cost to consumers without any decrease in demand for Bud Light and other brands. The question is, if tariffs lead to price increases, will Americans drink less beer? Will Bud Light fans exhibit elastic demand curves or inelastic demand curves?

Low inflation presents pricing challenges of a different type. With inflation in the United States in the low single digits in the late 1990s and strong demand forcing factories to run at or near capacity, companies should have been able to raise prices. However, the domestic economic situation was not the only consideration in pricing decisions made in that era. In the mid-1990s, excess manufacturing capacity in many industries, high rates of unemployment in many European countries, and the lingering recession in Asia made it difficult for companies to increase prices. As John Ballard, CEO of a California-based engineering firm, noted in 1994, "We thought about price increases. But our research of competitors and what the market would bear told us it was not worth pursuing." By the end of the decade, globalization, the Internet, a flood of low-cost exports from China, and a new cost-consciousness among buyers were also significant price-constraining factors.[20]

Government Controls, Subsidies, and Regulations

Governmental policies and regulations that affect pricing decisions include dumping legislation, resale price maintenance legislation, price ceilings, and general reviews of price levels. Government actions that limit management's ability to adjust prices can put pressure on margins. Under certain conditions, government actions may pose a threat to the profitability of a subsidiary operation. In a country that is undergoing severe financial difficulties and is in the midst of a financial crisis (e.g.,a foreign exchange shortage caused in part by runaway inflation), for example, government officials are under pressure to take some type of action. This was true in Brazil for many years. In some cases, governments take expedient steps such as selective or broad price controls.

When selective controls are imposed, foreign companies are more vulnerable to control than local ones, particularly if the outsiders lack the political influence over government decisions that local managers have. For example, Procter & Gamble encountered strict price controls in Venezuela in the late 1980s. Despite increases in the cost of raw materials, P&G was granted only about 50 percent of the price increases it requested; even then, months passed before permission to raise prices was forthcoming. As a result, by 1988, detergent prices in Venezuela were less than detergent prices in the United States.[21]

Government control can also take other forms. As discussed in Chapter 8, companies are sometimes required to deposit funds in a non-interest-bearing escrow account for a specified period of time if they wish to import products. In one case, Cintec International, an engineering firm that specializes in restoring historic structures, spent 8 years seeking the necessary approval from Egyptian authorities to import special tools to repair a mosque. In addition, the country's port authorities required a deposit of nearly $25,000 before they allowed Cintec to import diamond-tipped drills and other special tools. Why would Cintec's management accept such conditions? Cairo is the largest city in the Muslim world, and hundreds of its centuries-old historic structures are in need of refurbishment. By responding to the Egyptian government's demands with patience and persistence, Cintec was positioning itself as a leading contender for more contract work.[22]

Cash deposit requirements such as the one just described clearly create an incentive for a company to minimize the stated value of the imported goods; lower prices mean smaller deposits. Other government requirements that affect the pricing decision are profit transfer rules that restrict the conditions under which profits can be transferred out of a country. Under such rules, a high transfer price paid for imported goods by an affiliated company can be interpreted as a device for transferring profits out of a country.

Also discussed in Chapter 8 were government subsidies. As noted there, the topic of agricultural subsidies is a sensitive one in the current round of global trade talks. Brazil and a bloc of more than 20 other nations are pressing the United States to end agricultural subsidies. For example, the United States spends between $2.5 billion and $3 billion per year on cotton subsidies (the European Union spends the equivalent of $700 million), a fact that has contributed to delays in completing trade talks. Benin, Chad, Burkina Faso, and other countries complain that the subsidies keep U.S. cotton prices so low that the African nations lose $250 million each year in exports.[23] Brazil recently won its World Trade Organization (WTO) complaint against U.S. cotton subsidies. Meanwhile, in Uzbekistan, the government is finally beginning to address a human-rights abuse issue: For years, doctors, teachers, and students have been pressed into service during the cotton harvest.[24]

Government regulations can also affect prices in other ways. In Germany, for example, price competition was historically severely restricted in a number of industries, especially in the service sector. The German government's recent moves toward deregulation have improved the climate for market entry by foreign firms in a range of industries, including insurance, telecommunications, and air travel. Deregulation is also giving German companies their first experience of price competition in the domestic market. In some instances, deregulation represents a *quid pro quo* that will allow German companies wider access to other country markets.

For example, in the late 1990s, the United States and Germany completed an open-skies agreement that allows Lufthansa to fly more routes within the United States. At the same time, the German air market has been opened to competition. Thanks to newcomers like Air Berlin, Ryanair, and easyJet, air travel costs to and from Germany have fallen significantly. The past two decades have seen slow changes within the retail sector as well. The Internet and globalization have forced policymakers to repeal two archaic laws. The first, the *Rabattgesetz*, or Discount Law, limited discounts on products to 3 percent of the list price. The second, the *Zugabeverordung*, or Free Gift Act, banned companies from giving away free merchandise such as shopping bags.[25]

Competitive Behavior

Pricing decisions are bounded not only by cost and the nature of demand, but also by competitive action. If competitors do not adjust their prices in response to rising costs, management—even if acutely aware of the effect of rising costs on operating margins—will be severely constrained in its ability to adjust prices accordingly. Conversely, if competitors are manufacturing or sourcing in a lower-cost country, it may be necessary to cut prices to stay competitive.

In the United States, Levi Strauss & Company is under price pressure from several directions. First, Levi's face stiff competition from the Wrangler and Lee brands marketed by VF Corporation. A pair of Wrangler jeans retails for about $20 at JCPenney and other department stores, compared with about $30 for a pair of Levi's 501 jeans. Second, the two primary retail customers for Levi's, JCPenney and Sears, are aggressively marketing their own private-label brands. Finally, designer jeans from Calvin Klein, Polo, and Diesel are enjoying renewed popularity. Exclusive fashion brands such as 7 for All Mankind and Lucky retail for more than $100 per pair.

Outside the United States, thanks to the heritage of the Levi's brand and less competition, Levi's jeans command premium prices—$80 or more for one pair of 501 jeans. To support their prestige image, Levi's are sold in boutiques. Levi's non-U.S. sales represent about one-third of revenues but more than 50 percent of profits. In an attempt to apply its global experience and enhance the brand in the United States, Levi has opened a number of Original Levi's Stores in selected American cities. Despite such efforts, Levi rang up only $4.5 billion in sales in 2016, compared with $7.1 billion in 1996. More than a decade ago, the company closed six plants and moved most of its North American production offshore in an effort to cut costs.[26]

Using Sourcing as a Strategic Pricing Tool

The global marketer has several options for addressing the problem of price escalation or the environmental factors described in the last section. Product and market competition, in part, dictate the marketer's choices. Marketers of domestically manufactured finished products may be forced to switch to offshore sourcing of certain components to keep costs and prices competitive. In particular, China is quickly gaining a reputation as "the world's workshop." For example, U.S. bicycle companies such as Huffy are relying more heavily on production sources in China and Taiwan.

Another option is a thorough audit of the distribution structure in the target markets. A rationalization of the distribution structure can substantially reduce the total markups required to achieve distribution in international markets. Rationalization may include selecting new intermediaries, assigning new responsibilities to old intermediaries, or establishing direct marketing operations. For years, Toys 'R' Us successfully targeted the Japanese toy market by bypassing layers of distribution and adopting a warehouse style of selling similar to its U.S. approach. Toys 'R' Us was viewed as a test case of the ability of Western retailers—discounters, in particular—to change the rules of distribution. By early 2018, though, times had changed: Toys 'R' Us management announced the company was closing all of its 885 U.S. stores and was seeking a buyer for its international operations.

11-5 Global Pricing: Three Policy Alternatives

11-5 Apply the ethnocentric/polycentric/geocentric framework to decisions regarding price.

What pricing policy should a global company pursue? Recall that price is a strategic variable; pricing strategy can be developed using a rational, analytical approach or an intuitive one. For example, when Sydney Frank created Grey Goose vodka, he set the per-bottle price $10 higher than that of Stolichnaya or Absolut. Why? Because he could! Frank did not conduct any form of market analysis. Instead, he relied on instinct and insights gained during a long career in the liquor business. Similar examples of simple decision rules used in pricing include the following:

- "We have our competitor's price list on our desk . . . . We know exactly what our competitors charge for certain products, and we calculate accordingly."
- "We differentiate simply because there are some countries where we can get a better price. Then there are countries where we can't."[27]

Viewed broadly, a company has three positions it can take on worldwide pricing.

Extension or Ethnocentric Pricing

The first position, known as **extension or ethnocentric pricing**, calls for the per-unit price of an item to be the same no matter where in the world the buyer is located. In such instances, the importer must absorb freight and import duties. The extension approach has the advantage of extreme simplicity because it does not require information on competitive or market conditions for implementation. Its main disadvantage is that the ethnocentric approach does not respond to the competitive and market conditions of each national market and, therefore, does not maximize the company's profits in each national market or globally. When toymaker Mattel adapted U.S. products for overseas markets, for example, little consideration was given to the price levels that would result when U.S. prices were converted to local currency prices. As a result, Holiday Barbie and some other toys were overpriced in global markets.[28]

Similarly, Mercedes executives moved beyond an ethnocentric approach to pricing. As Dieter Zetsche, chairman of Daimler AG, noted, "We used to say that *we* know what the customer wants, and he will have to pay for it . . . we didn't realize the world had changed."[29] Mercedes got its wake-up call when Lexus began offering "Mercedes quality" for $20,000 less. After assuming the top position in the company in 1993, Mercedes CEO Helmut Werner boosted employee productivity, increased the number of low-cost outside suppliers, and invested in production facilities in the United States and Spain in an effort to move toward more customer- and competition-oriented pricing. The company also rolled out new, lower-priced versions of its E Class and S Class sedans.

Advertising Age immediately hailed management's new attitude for transforming Mercedes from "a staid and smug purveyor into an aggressive, market-driven company that will go bumper-to-bumper with its luxury car rivals—even on price."[30]

Apple learned an important lesson about the potential drawbacks of ethnocentric pricing in China, where many smartphone apps give users the ability to "tip" each other by sending yuan as an acknowledgment of user-created content. Apple's policy is to take 30 percent of fees generated by apps, and it initially applied this policy in China, where it considered "tipping" to be an in-app purchase. By contrast, Tencent Holding's popular WeChat app did not charge for tipping. In response to complaints about its own pricing, Apple changed its policy.[31]

Adaptation or Polycentric Pricing

The second policy, **adaptation or polycentric pricing**, permits subsidiary or affiliate managers or independent distributors to establish whatever price they believe is most appropriate in their market environment. There is no requirement that prices be coordinated from one country to the next. IKEA takes a polycentric approach to pricing: While it is company policy to have the lowest price on comparable products in every market, managers in each country set their own prices. These depend, in part, on local factors such as competition, wages, taxes, and advertising rates. Overall, IKEA's prices are lowest in the United States, where the company competes with large retailers. Prices are higher in Italy, where local competitors tend to be smaller, more upscale furniture stores than those in the U.S. market. Generally, prices are higher in countries where the IKEA brand is strongest. When IKEA opened its first stores in mainland China, the young professional couples who are the company's primary target segment considered the prices to be too high. Ian Duffy, an Englishman in charge of the stores, quickly increased the amount of Chinese-made furniture in the stores so that he could lower prices; today, the average Chinese customer spends ¥300—about $36—per visit.[32]

> **"The practice of selling U.S. products abroad at prices keyed to the local market is longstanding. It's not unusual, it doesn't violate public policy, and it's certainly not illegal."[33]**
>
> Allen Adler, American Association of Publishers

One recent study of European industrial exporters found that companies utilizing independent distributors were the most likely to utilize polycentric pricing. Such an approach is sensitive to local market conditions, but valuable knowledge and experience within the corporate system concerning effective pricing strategies are not brought to bear on each local pricing decision. Because the distributors or local managers are free to set prices as they see fit, they may ignore the opportunity to draw upon company experience. Arbitrage is also a potential problem with the polycentric approach: When disparities in prices between different country markets exceed the transportation and duty costs separating the markets, enterprising individuals can purchase goods in the lower-price country market and then transport them for sale in markets where higher prices prevail.

This is precisely what has happened in both the pharmaceutical and textbook publishing industries. Discounted drugs intended for patients with acquired immunodeficiency syndrome (AIDS) in Africa have been smuggled into the European Union and sold at a huge profit. Similarly, Pearson (which publishes this text), McGraw-Hill, Thomson, and other publishers typically set lower prices in Europe and Asia than in the United States. The reason is that the publishers use polycentric pricing: They establish prices on a regional or country-by-country basis using per capita income and economic conditions as a guide. (By the way, authors have no control over the prices that university bookstores and other retailers charge for textbooks. Trust us on this one!)

Geocentric Pricing

The third approach, **geocentric pricing**, is more dynamic and proactive than the other two. A company using geocentric pricing neither fixes a single price worldwide, nor allows subsidiaries or local distributors to make independent pricing decisions. Instead, the geocentric approach represents an intermediate course of action. Geocentric pricing is based on the realization that unique local market factors should be recognized when arriving at pricing decisions. These factors include local costs, income levels, competition, and the local marketing strategy. Price must also be integrated with other elements of the marketing program. The geocentric approach recognizes that price coordination from headquarters is necessary in dealing with international accounts and product arbitrage. This approach also consciously and systematically seeks to ensure that accumulated national pricing experience is leveraged and applied wherever relevant.

With geocentric pricing, local costs plus a return on invested capital and personnel fix the price floor for the long term. In the short term, however, headquarters might decide to set a market penetration objective and price at less than the cost-plus return figure by using export sourcing to establish a market. This was the case described earlier with the Sony Walkman launch. Another short-term objective might be to arrive at an estimate of the market potential at a price that would be profitable given local sourcing and a certain volume of production. Instead of immediately investing in local manufacture, a decision might be made to supply the target market initially from existing higher-cost external supply sources. If the market accepts the price and product, the company can then build a local manufacturing facility to further develop the identified market opportunity in a profitable way. If the market opportunity does not materialize, the company can experiment with the product at other prices because it is not committed to a fixed sales volume by existing local manufacturing facilities.

11-6 Gray Market Goods

11-6 Explain some of the tactics global companies can use to combat the problem of gray market goods.

Gray market goods are trademarked products that are exported from one country to another and sold by unauthorized persons or organizations. Consider the following illustration:

> Suppose that a golf equipment manufacturer sells a golf club to its domestic distributors for $200; it sells the same club to its Thailand distributor for $100. The lower price may be due to differences in overseas demand or ability to pay. Alternatively, the price difference may reflect the need to compensate the foreign distributor for advertising and marketing the club. But the golf club never actually makes it to Thailand: Instead, the Thailand distributor resells the club to a gray marketer in the United States for $150. The gray marketer can then undercut the prices charged by domestic distributors who paid $200 for the club. The manufacturer is forced to lower the domestic price or risk losing sales to gray marketers, driving down the manufacturer's profit margins. Additionally, gray marketers make liberal use of manufacturers' trademarks and often fail to provide warranties and other services that consumers expect from the manufacturer and its authorized distributors.[34]

This practice, known as **parallel importing**, occurs when companies employ a polycentric, multinational pricing policy that calls for setting different prices in different country markets. Gray markets can flourish when a product is in short supply, when producers employ skimming strategies in certain markets, or when the goods are subject to substantial markups. For example, in the European pharmaceuticals market, prices vary widely. In the United Kingdom and the Netherlands, parallel imports account for as much as 10 percent of the sales of some pharmaceutical brands. The Internet serves as a powerful tool that allows would-be gray marketers to access pricing information and reach customers.[35]

Gray markets impose several costs or consequences on global marketers, including the following:[36]

- *Dilution of exclusivity.* Authorized dealers are no longer the sole distributors. The product is often available from multiple sources and margins are threatened.
- *Free riding.* If the manufacturer ignores complaints from authorized channel members, those members may engage in free riding. In this practice, channel members may opt to take various actions to offset the downward pressure on margins, such as cutting back on presale service, customer education, and salesperson training.
- *Damage to channel relationships.* Competition from gray market products can lead to channel conflict as authorized distributors attempt to cut costs, complain to manufacturers, and file lawsuits against the gray marketers.
- *Undermining segmented pricing schemes.* As noted earlier, gray markets can emerge because of price differentials that result from multinational pricing policies. However, a variety of forces—including falling trade barriers, the information explosion on the Internet, and modern distribution capabilities—hamper a company's ability to pursue local pricing strategies.
- *Reputation and legal liability.* Even though gray market goods carry the same trademarks as goods sold through authorized channels, they may differ in quality, ingredients, or some other way. Gray market products can compromise a manufacturer's reputation and dilute

brand equity, as when prescription drugs are sold past their expiration dates or electronics equipment is sold in markets where it is not approved for use or where manufacturers do not honor warranties.

Sometimes, gray marketers bring a product produced in a single country—French Champagne, for example—into export markets in competition with authorized importers. The gray marketers sell at prices that undercut those set by the legitimate importers. In another type of gray marketing, a company manufactures a product in the home-country market as well as in foreign markets. In this case, products manufactured abroad by the company's foreign affiliate for sales abroad are sometimes sold by a foreign distributor to gray marketers. The latter then bring the products into the producing company's home-country market, where they compete with domestically produced goods.

As these examples show, the marketing opportunity that presents itself requires gray market goods to be priced lower than goods sold by authorized distributors or domestically produced goods. Clearly, buyers gain from lower prices and increased choice. In the United Kingdom alone, total annual retail sales of gray market goods are estimated to be in the billions of pounds Sterling.

A case in Europe resulted in a ruling that strengthened the rights of brand owners. Silhouette, an Austrian manufacturer of upscale sunglasses, sued the Hartlauer discount chain after the retailer obtained thousands of pairs of sunglasses that Silhouette had intended for sale in Eastern Europe. The European Court of Justice found in favor of Silhouette. In clarifying a 1989 directive, the court ruled that stores cannot import branded goods from outside the European Union and then sell them at discounted prices without permission of the brand owner. However, the *Financial Times* denounced the ruling as "bad for consumers, bad for competition, and bad for European economies."[37]

"The gray market is the biggest threat we have. You can't develop this market properly and make investments in retailing, merchandising, after-sales service and distribution without a legal market."[38]

Pankaj Mohindroo, president, Indian Cellular Association

In the United States, gray market goods are subject to the Tariff Act of 1930. Section 526 of the act expressly forbids importation of goods of foreign manufacture without the permission of the trademark owner. However, because courts have considerable leeway in interpreting the act, one legal expert has argued that the U.S. Congress should repeal Section 526. In its place, a new law might require gray market goods to bear labels clearly explaining any differences between them and goods that come through authorized channels. Other experts believe that instead of changing the laws, companies should develop proactive strategic responses to gray markets. One such strategy would be improved market segmentation and product differentiation to make gray market products less attractive; another would be to aggressively identify and terminate distributors that are involved in selling to gray markets.

11-7 Dumping

▶ **11-7** Assess the impact of dumping on prices in global markets.

Dumping is an important global pricing strategy issue. The General Agreement on Tariff and Trade's (GATT) 1979 antidumping code defined *dumping* as the sale of an imported product at a price lower than that normally charged in a domestic market or country of origin. In addition, many countries have their own policies and procedures for protecting national companies from dumping. For example, China has retaliated against years of Western antidumping rules by introducing rules of its own. China's State Council passed the Antidumping and Antisubsidy Regulations in March 1997. The Ministry of Foreign Trade and Economic Cooperation and the State Economic and Trade Commission have responsibility for antidumping matters.[39]

"Dumping is the single most immediate threat for the whole of the European steel industry. Excess steel capacity in a truly global market helps no one in the long term."[40]

Geert van Poelvoorde, president, Eurofer

The U.S. Congress has defined *dumping* as an unfair trade practice that results in "injury, destruction, or prevention of the establishment of American industry." Under this definition, dumping occurs when imports sold in the U.S. market are priced either at levels that represent less than the cost of production plus an 8 percent profit margin or at levels below those prevailing in the producing country. The U.S. Commerce Department is responsible for determining whether products are being dumped in the United States; the International Trade Commission (ITC) then determines whether the dumping has resulted in injury to U.S. firms.

Many of the dumping cases in the United States involve manufactured goods from Asia and frequently target a single or very narrowly defined group of products. U.S. companies that claim to be materially damaged by the low-priced imports often initiate such cases. In 2000, the U.S.

Congress passed the so-called **Byrd Amendment**; this law calls for antidumping revenues to be paid to U.S. companies harmed by imported goods sold at below-market prices.[41]

In Europe, the European Commission administers antidumping policy; a simple majority vote by the Council of Ministers is required before duties can be imposed on dumped goods. Six-month provisional duties can be imposed, while more stringent measures include definitive, 5-year duties. In the past, low-cost imports from Asia have been the subject of dumping disputes in Europe. Another issue concerned $650 million in annual imports of unbleached cotton from China, Egypt, India, Indonesia, Pakistan, and Turkey. One dispute pitted an alliance of textile importers and wholesalers against Eurocoton, which represents textile weavers in France, Italy, and other EU countries. Eurocoton supported duties as a means of protecting jobs from low-priced imports; the job issue was particularly sensitive in France. British textile importer Broome & Wellington maintained, however, that imposing duties would drive up prices and cost even more jobs in the textile finishing and garment industries.[42] In January 2005, the global system of textile quotas was abolished. Almost overnight, Chinese textile exports to the United States and Europe increased dramatically. Within a few months, the U.S. government had re-imposed quotas on several categories of textile imports; in the European Union, trade minister Peter Mandelson also imposed quotas for a period of 2 years.

Dumping was a major issue in the Uruguay Round of GATT negotiations. Many countries took issue with the U.S. system of antidumping laws, in part because historically the U.S. Commerce Department has almost always ruled in favor of the U.S. company that filed the complaint. For their part, U.S. negotiators were concerned that U.S. exporters were often targeted in antidumping investigations in countries with few formal rules for due process. The U.S. side sought to improve the ability of U.S. companies to defend their interests and understand the bases for rulings.

The result of the GATT negotiations was an agreement on interpretation of GATT Article VI. From the U.S. point of view, one of the most significant changes between the agreement and the 1979 code is the addition of a "standard of review" that will make it harder for GATT panels to dispute U.S. antidumping determinations. A number of procedural and methodological changes were also made. In some instances, these have the effect of bringing GATT regulations more in line with U.S. law. For example, in calculating the "fair price" for a given product, any sales of the product at below-cost prices in the exporting country are not included in the calculations; inclusion of such sales would have the effect of exerting downward pressure on the fair price. The agreement also aligned GATT standards with U.S. standards by prohibiting governments from penalizing differences between home-market and export-market prices of less than 2 percent.

To provide positive proof that dumping has occurred in the United States, the complainant must demonstrate that both price discrimination and injury occurred. *Price discrimination* is the practice of setting different prices when selling the same quantity of "like-quality" goods to different buyers. The existence of either one without the other is an insufficient condition to constitute dumping.

Companies concerned with running afoul of antidumping legislation have developed a number of approaches for avoiding these laws. One approach is to differentiate the product sold from that in the home market so it does not represent "like quality." An example is an auto accessory that one company packaged with a wrench and an instruction book, thereby changing the "accessory" to a "tool." The duty rate in the export market happened to be lower on tools, and the company also acquired immunity from antidumping laws because the package was not comparable to competing goods in the target market. Another approach is to make nonprice competitive adjustments in arrangements with affiliates and distributors. For example, credit can be extended, which essentially has the same effect as a price reduction.

11-8 Price Fixing

◀ **11-8** Compare and contrast the different types of price fixing.

In most instances, it is illegal for representatives of two or more companies to secretly agree to set similar prices for their products. This practice, known as **price fixing**, is generally held to be an anticompetitive act. Companies that collude in this manner are usually trying to ensure higher prices for their products than would generally be available if markets were functioning freely. In *horizontal price fixing*, competitors within an industry that make and market the same product conspire to keep prices high. For example, in 2011 the European Commission determined that P&G, Unilever, and Henkel had conspired to set prices for laundry detergent. The term *horizontal* applies in this instance because P&G and its co-conspirators are all at the same supply-chain "level" (i.e., they are manufacturers).

Vertical price fixing occurs when a manufacturer conspires with wholesalers or retailers (i.e., channel members at different "levels" from the manufacturer) to ensure certain retail prices are maintained. The European Commission once fined Nintendo nearly $150 million after it was determined that the video game company had colluded with European distributors to fix prices. During the 1990s, prices of Nintendo video game consoles varied widely across Europe. The devices were much more expensive in Spain than in Britain and other countries; however, distributors in countries with lower retail prices agreed not to sell to retailers in countries with higher prices.[43]

Another case of price fixing pitted DeBeers SA, the South African diamond company, against the United States. At issue were prices for industrial diamonds, not gemstones; however, DeBeers is a well-known name in the United States thanks to a long-running advertising campaign keyed to the tagline "A Diamond Is Forever." Because the company itself has no American retail presence, DeBeers diamonds are marketed in the United States by intermediaries. DeBeers executives reached a plea agreement and paid a $10 million fine in exchange for access to the U.S. market. As a spokesperson said in the months leading up to the plea, "The U.S. is the biggest market for diamond jewelry—accounting for 50 percent of global retail jewelry sales—and we would really, really like to resolve these issues."[44]

▶ **11-9** Explain the concept of transfer pricing.

11-9 Transfer Pricing

Transfer pricing refers to the pricing of goods, services, and intangible property bought and sold by operating units or divisions of the same company. In other words, transfer pricing concerns *intracorporate exchanges*, which are transactions between buyers and sellers that have the same corporate parent. For example, Toyota subsidiaries both sell to, and buy from, each other. Transfer pricing is an important topic in global marketing because goods crossing national borders represent a sale; therefore, their pricing is a matter of interest both to the tax authorities, which want to collect a fair share of income taxes, and to the customs service, which wants to collect an appropriate duty on the goods. Joseph Quinlan, chief marketing strategist at Bank of America, estimates that U.S. companies have 23,000 overseas affiliates; approximately 25 percent of U.S. exports represent shipments by American companies to affiliates and subsidiaries outside the United States.

In determining transfer prices to subsidiaries, global companies must address a number of issues, including taxes, duties and tariffs, country profit transfer rules, conflicting objectives of joint-venture partners, and government regulations. Tax authorities such as the Internal Revenue Service (IRS) in the United States, Inland Revenue in the United Kingdom, and Japan's National Tax Administration Agency take a keen interest in transfer pricing policies.[45] Transfer pricing is proving to be a key corporate issue in Europe as the euro makes it easier for tax authorities to audit transfer pricing policies.

Three major alternative approaches can be applied to transfer pricing decisions. The approach used will vary with the nature of the firm, the products, the markets, and the historical circumstances of each case. A **market-based transfer price** is derived from the price required to be competitive in the global marketplace. In other words, it represents an approximation of an arm's-length transaction. **Cost-based transfer pricing** uses an internal cost as the starting point in determining price. This kind of transfer pricing can take the same forms as the cost-based pricing methods discussed earlier in the chapter. The way costs are defined may have an impact on tariffs and duties of sales to affiliates and subsidiaries. A third alternative is to allow the organization's affiliates to determine **negotiated transfer prices** among themselves. This method may be employed when market conditions are subject to frequent changes. Table 11-3 summarizes the ways that the different methods satisfy multiple managerial criteria.

Tax Regulations and Transfer Prices

Because global companies conduct business in a world characterized by different corporate tax rates, companies have an incentive to maximize income in countries with the lowest tax rates—Ireland is a prime example—and to minimize income in the United States and

TABLE 11-3 Comparison of Different Transfer Pricing Methods

Criteria	Market-Based	Cost-Based	Negotiated
Achieves goal congruence	Yes, when markets are competitive	Often, but not always	Yes
Motivates managerial effort	Yes	Yes, when based on budgeted costs	Yes
Useful for evaluating subunit performance	Yes, when markets are competitive	Difficult unless transfer price exceeds full cost	Yes, but transfer prices are affected by the negotiating skills of the buyer and the seller
Preserves subunit autonomy	Yes, when markets are competitive	No, because it is rule-based	Yes, because it is based on negotiations between subunits
Other factors	Markets may not exist or may be imperfect	Useful for determining the full cost of products; easy to implement	Bargaining and negotiations take time and may need to be reviewed as conditions change

Source: Adapted from Charles T. Horngren, Srikant M. Datar, George Foster, Madhav Rajan, and Christopher Ittner, *Cost Accounting: A Managerial Emphasis* (Upper Saddle River, NJ: Prentice Hall, 2009), p. 783.

other countries with high tax rates. As we discussed in Chapter 5, governmental regulatory agencies are well aware that Apple and other companies formulate strategies for tax planning and tax minimization.[46] In recent years, many governments have tried to maximize national tax revenues by examining company returns and mandating reallocation of income and expenses. Among the companies that have become involved in transfer pricing cases are the following:

- The IRS sought as much as $500 million in back taxes on earnings from Motorola's global operations that were allegedly booked incorrectly.
- The U.S. Labor Department filed a complaint against Swatch Group alleging that the Swiss watchmaker improperly used transfer pricing to evade millions of dollars in customs duties and taxes.[47]
- The U.S. government spent years attempting to recover $2.7 billion plus interest from pharmaceutical giant GlaxoSmithKline (GSK). The IRS charged that GSK did not pay enough tax on profits from Zantac, its hugely successful ulcer medication. Between 1989 and 1999, U.S. revenues from Zantac totaled $16 billion; the IRS charged that GSK's American unit overpaid royalties to the British parent company, thereby reducing taxable U.S. income. The case was scheduled for trial in 2007; however, in September 2006, GSK settled the case by agreeing to pay the IRS approximately $3.1 billion.[48]

Sales of Tangible and Intangible Property

Each country has its own set of laws and regulations for dealing with controlled intracompany transfers. Whatever the pricing rationale, executives and managers involved in global pricing policy decisions must familiarize themselves with the laws and regulations in the applicable countries. The pricing rationale must conform with the intention of these laws and regulations. Although the applicable laws and regulations often seem perplexingly inscrutable, ample evidence exists that most governments simply seek to prevent tax avoidance and to ensure fair distribution of income from the operations of companies doing business internationally.

Even companies that make a conscientious effort to comply with the applicable laws and regulations and that document this effort may find themselves in tax court. Should a tax auditor raise questions, executives must be able to make a strong case for their decisions. Fortunately, consulting services are available to help managers deal with the arcane world of transfer pricing. It is not unusual for large global companies to invest hundreds of thousands of dollars and hire international accounting firms to review transfer pricing policies.

▸ **11-10** Define *countertrade* and explain the various forms it can take.

11-10 Countertrade

In recent years, many exporters have been forced to finance international transactions by taking full or partial payment in some form other than money.[49] A number of alternative finance methods, known as *countertrade*, are widely used. In a **countertrade** transaction, a sale results in product flowing in one direction to a buyer; a separate stream of products and services, often flowing in the opposite direction, is also created. Countertrade generally involves a seller from the West and a buyer in a developing country; for example, the countries in the former Soviet bloc have historically relied heavily on countertrade. This approach, which reached a peak in popularity in the mid-1980s, is now used in some 100 countries. Within the former Soviet Union, countertrade flourished in the 1990s, following the collapse of the central planning system.

As one expert noted, countertrade flourishes when hard currency is scarce. Exchange controls may prevent a company from expatriating earnings; the company may be forced to spend money in-country for products that are then exported and sold in third-country markets. Historically, the single most important driving force behind the proliferation of countertrade was the decreasing ability of developing countries to finance imports through bank loans. This trend resulted in debt-ridden governments pushing for self-financed deals.[50]

Generally, several conditions affect the probability that some form of countertrade will be used.

- *The priority attached to the import.* The higher the priority, the less likely it is that countertrade will be required.
- *The value of the transaction.* The higher the value, the greater the likelihood that countertrade will be involved.
- *The availability of products from other suppliers.* If a company is the sole supplier of a differentiated product, it can demand monetary payment.

In the past decade, the debt crisis in Europe prompted some companies to consider using countertrade. German chemical giant BASF has a contingency plan to accept countertrade deals with Greek buyers in the agricultural sector. Such deals are not new for BASF; in Eastern Europe, for example, the company has accepted minerals as payment for its chemical products. Some customers in Brazil even pay with molasses! Fried-Walter Muenstermann, the CFO for BASF, says his company will be selective with new countertrade deals in Europe: "We don't need wine and olive oil."[51]

Two categories of countertrade are discussed here. Barter falls into one category; the mixed forms of countertrade, including counterpurchase, offset, compensation trading, and switch trading, belong in a separate category. They incorporate a real distinction from barter because the transaction involves money or credit.

Barter

The term **barter** describes the least complex and oldest form of bilateral, nonmonetized countertrade. Simple barter is a direct exchange of goods or services between two parties. Although no money is involved, both partners construct an approximate shadow price for products flowing in each direction. To make these arrangements, companies sometimes seek outside help from barter specialists. For example, New York–based Atwood Richards engages in barter in all parts of the world. More often, distribution of the bartered items occurs directly between the trading partners, with no intermediary included.

In the annals of global marketing, PepsiCo was one of the highest-profile companies involved in barter deals. Pepsi has done business in the Soviet and post-Soviet market for decades. In the Soviet era, when the ruble could not be converted to dollars or other "hard" currencies, PepsiCo bartered soft drink syrup concentrate for Stolichnaya vodka. The vodka was exported to the United States by the PepsiCo Wines & Spirits subsidiary and marketed by M. Henri Wines. In the post-Soviet market economy, Russian rubles are freely convertible, and barter is no longer required. Today, Stolichnaya is imported and distributed by Stoli Group, a unit of Luxembourg-based SPI Group.

A cornerstone of the late Venezuelan president Hugo Chávez's economic policy was bartering oil to foster closer relations with other Latin American countries. Cuba sent doctors to Venezuela in exchange for oil; other countries "paid" for oil with bananas or sugar. More recently, shortages in goods have forced Venezuelans to barter for their daily needs using WhatsApp, Facebook, and Instagram. Sample trades: Pasta and sugar for diapers; flour for shampoo; and Colombian toilet paper for pantry staples.[52]

Counterpurchase

The **counterpurchase** form of countertrade, also termed *parallel trading* or *parallel barter*, is distinguished from other forms of countertrade in that each delivery in an exchange is paid for in cash. For example, Rockwell International sold a printing press to Zimbabwe for $8 million—but the deal went through only after Rockwell agreed to purchase $8 million in ferrochrome and nickel from Zimbabwe. It subsequently sold those ores on the world market.

The Rockwell–Zimbabwe deal illustrates several aspects of counterpurchase. Generally, products offered by the foreign principal are not related to the Western firm's exports and cannot be used directly by the firm. In most counterpurchase transactions, two separate contracts are signed. In one contract, the supplier agrees to sell products for a cash settlement (the original sales contract); in the other, the supplier agrees to purchase and market unrelated products from the buyer (a separate, parallel contract). The dollar value of the counterpurchase generally represents a set percentage—and sometimes the full value—of the products sold to the foreign principal. When the Western supplier sells these goods, the trading cycle is complete.

Offset

Offset is a reciprocal arrangement whereby the government in the importing country seeks to recover large sums of hard currency spent on expensive purchases such as military aircraft or telecommunications systems. In effect, the government is saying, "If you want us to spend government money on your exports, you must import products from our country." Offset arrangements may also involve cooperation in manufacturing, some form of technology transfer, placing subcontracts locally, or arranging local assembly or manufacturing equal to a certain percentage of the contract value.[53] In one deal involving offsets, Lockheed Martin sold F-16 fighters to the United Arab Emirates for $6.4 billion. In return, Lockheed Martin agreed to invest $160 million in the petroleum-related UAE Offsets Group.[54]

Offset may be distinguished from counterpurchase in that the latter is characterized by smaller deals over shorter periods of time.[55] Another major distinction between offset and other forms of countertrade is that the agreement is not contractual, but rather reflects a memorandum of understanding that sets out the dollar value of products to be offset and the time period for completing the transaction. In addition, there is no penalty on the supplier for nonperformance. Typically, requests range from 20 to 50 percent of the value of the supplier's product. Some highly competitive sales have required offsets exceeding 100 percent of the valuation of the original sale.

Offsets have become a controversial aspect of today's trade environment. To win sales in important markets such as China, global companies can face demands for offsets even when transactions do not involve military procurement. For example, the Chinese government requires Boeing to spend 20 to 30 percent of the price of each aircraft on purchases of Chinese goods. As former Boeing executive Dean Thornton once explained:

> "Offset" is a bad word, and it's against GATT and a whole bunch of other stuff, but it's a fact of life. It used to be 20 years ago in places like Canada or the UK, it was totally explicit, down to the decimal point. "You will buy 20 percent offset of your value." Or 21 percent or whatever. It still is that way in military stuff. [With sales of commercial aircraft], it's not legal so it becomes less explicit.[56]

Compensation Trading

Compensation trading, also called *buyback*, is a form of countertrade that involves two separate and parallel contracts. In one contract, the supplier agrees to build a plant or provide plant equipment, patents or licenses, or technical, managerial, or distribution expertise for a hard-currency down payment at the time of delivery. In the other contract, the supplier company agrees to take payment in the form of the plant's output equal to its investment (minus interest) for a period of as many as 20 years.

Essentially, the success of compensation trading rests on the willingness of each firm to be both a buyer and a seller. China has used compensation trading extensively. Egypt also used this approach to develop an aluminum plant. A Swiss company, Aluswiss, built the plant and also exports alumina (an oxide of aluminum found in bauxite and clay) to Egypt. Aluswiss takes back a percentage of the finished aluminum produced at the plant as partial payment for building the plant. As this example shows, compensation differs from counterpurchase in that the technology or capital supplied in the former is related to the output produced.[57] In counterpurchase, as noted earlier, the goods taken by the supplier typically cannot be used directly in its business activities.

Switch Trading

Also called *triangular trade* and *swap*, **switch trading** is a mechanism that can be applied to barter or countertrade. In this arrangement, a third party steps into a simple barter or other countertrade arrangement when one of the parties is not willing to accept all the goods received in a transaction. The third party may be a professional switch trader, a switch trading house, or a bank. The switching mechanism provides a "secondary market" for countertraded or bartered goods and reduces the inflexibility inherent in barter and countertrade. Fees charged by switch traders range from 5 percent of market value for commodities to 30 percent for high-technology items. Switch traders develop their own networks of firms and personal contacts and are generally headquartered in Vienna, Amsterdam, Hamburg, or London. If a party to the original transaction anticipates that the products received in a barter or countertrade deal will be sold eventually at a discount by the switch trader, the common practice is to price the original products higher, build in "special charges" for port storage or consulting, or require shipment by the national carrier.

Summary

Pricing decisions are a critical element of the marketing mix that must reflect costs, competitive factors, and customer perceptions regarding value of the product. In a true global market, the *law of one price* would prevail. Pricing strategies include *market skimming*, *market penetration*, and *market holding*. Novice exporters frequently use the cost-plus method when setting prices. International terms of a sale such as *ex-works*, *DDP*, *FCA*, *FAS*, *FOB*, *CIF*, and *CFR* are known as *Incoterms* and specify which party to a transaction is responsible for covering various costs. These and other costs lead to *export price escalation*, the accumulation of costs that occurs when products are shipped from one country to another.

Expectations regarding currency fluctuations, inflation, government controls, and the competitive situation must also be factored into pricing decisions. The introduction of the euro has impacted price strategies in the European Union because of the improved *price transparency* it supports. Global companies can maintain competitive prices in world markets by shifting production sources as business conditions change. Overall, a company's pricing policies can be categorized as *ethnocentric*, *polycentric*, or *geocentric*.

Several other pricing issues must be taken into account in global marketing. The possibility of *gray market goods* arises because price variations between different countries lead to *parallel imports*. *Dumping* is another contentious issue that can result in strained relations between trading partners. *Price fixing* among companies is anticompetitive and illegal. *Transfer pricing* is an issue because of the sheer monetary volume of intracorporate sales and because country governments are anxious to generate as much tax revenue as possible. Various forms of *countertrade* play an important role in today's global environment. *Barter*, *counterpurchase*, *offset*, *compensation trading*, and *switch trading* are the main countertrade options.

Discussion Questions

11-1. What are the basic factors that affect price in any market? Which considerations enter into the pricing decision?
11-2. What are some of the effects of "dumping" on the country of origin?
11-3. Identify some of the environmental constraints on global pricing decisions.
11-4. What are the differences between "horizontal price fixing" and "vertical price fixing"?
11-5. What is a transfer price? Why is it an important issue for companies with foreign affiliates? Why did transfer pricing in Europe take on increased importance in 1999?
11-6. How do the ethnocentric, polycentric, and geocentric pricing strategies differ? Which would you recommend to a company that has global market aspirations?
11-7. In November 2018, China launched its first ever anti-dumping investigation against Australia. The subject of the investigation was barley. The Australians had not been dumping excess barley production in China; the latter was angered by Australian moves to stop the practice. Why is dumping such an issue to a country like Australia?
11-8. Compare and contrast the different forms of countertrade.

CASE 11-1 *Continued (refer to page 359)*

Global Automakers Target Low-Income Consumers

The Logan is a case study in driving down costs. Drivers turn on the ignition with an "old-fashioned," manual key; there is no cruise control. The windshield glass is nearly flat, which makes it less expensive to produce. The left and right outside mirrors are identical; the ashtrays are exactly the same as the ones used in another Renault model, the Espace. Similarly, Logan shares an engine and gearbox with Renault's Clio subcompact. For these and other components, high manufacturing volumes translate into economies of scale.

Production of the first Logan models began in Romania in 2004. The choice of an assembly site was dictated by simple economics: France's high labor rates and payroll taxes would have translated into an additional €1,000 ($1,400) cost per vehicle. The Logan was launched in India in April 2007 with a sticker price of about $10,000; the vehicle was manufactured by a joint venture between Renault and Mahindra & Mahindra (M&M), one of India's best-known industrial conglomerates. After a dispute between the partners, the joint venture was dissolved. Mahindra & Mahindra now produces Logans under a licensing agreement.

In 2008 a hatchback model, the Sandero, was introduced. It was followed in 2009 by the Duster sport-utility vehicle; the Lodgy debuted in 2012. In 2012, Renault sold a record 2.55 million vehicles, 25 percent of which were low-cost models. Sales were split roughly evenly between the Logan and entry-level Renault models. As it turned out, the geographic distribution of sales indicated that Renault's strategy was in trouble: Although the Logan was targeted at emerging markets, it was a big hit with consumers in affluent European countries.

How did this happen? Enterprising independent distributors bought Logans that were manufactured in Romania and exported them to France and other countries in Western Europe. This coincided with a shift in consumer attitudes; in light of the financial crisis happening at the time, it was not surprising that many young Europeans were of the opinion that cutting back on spending was a sensible thing to do. Indeed, surveys showed that a high proportion of twenty-something Europeans were "interested" or "very interested" in buying a low-cost car.

Nano

Even as Renault continued to refine its low-cost-car strategy, some in the industry were asking a tantalizing question: Could the auto companies come up with the optimal value proposition—small, no-frills, four-door cars that are safe to drive, stylish enough to appeal to the aspirations of first-time buyers, and yet sell for *half* the price of a Logan (or less)? Under the best of circumstances, creating such a vehicle would test the prowess of the world's best automotive engineers. The challenge was even more daunting in a business environment characterized by record prices for steel, resin, and other commodities and components. As the general manager for a sourcing and procuring company noted, "There are so many legacy costs built into a design, and trying to engineer those out is difficult. It's better to start with a clean sheet of paper and engineer low costs in."

Top executives at India's Tata Motors believed their company was up to the task, and the Nano is the evidence. The Nano's instrument panel is clustered in the middle of the dashboard so that Tata can offer both right- and left-hand-drive versions for export. Tata's target market is consumers in emerging markets who currently travel by scooter. Some environmentalists have warned about the negative impact of hundreds of thousands of new vehicles on India's already congested roads. Chairman Ratan Tata asserts that low-income families should be given access to the freedom that a car provides: "Should they be denied the right to independent transport?" he asks.

After an initial flurry of industry interest and positive press, the Nano program fell victim to bad luck and changing attitudes. For one thing, protesters objected to the location of the first assembly plant. After production finally began, there were several well-publicized incidents in which the cars caught fire. Many car buyers shopped the competition; one best-selling model was the $6,200 Maruti Suzuki Alto. It seemed that the market had spoken: Very few people wanted to be seen driving "the world's cheapest car." As Hormazd Sorabjee, editor of *India Autoweek*, noted, "The bottom of the pyramid continues to be where the action is, but the aspirations of people are moving up. People want to jump into something more substantial."

Industry analysts Arya Sen had a similar assessment. "Cars in India are aspirational, but this was positioned as a cheap product," he said.

Datsun

Tata Motors' announcement about the Nano galvanized Carlos Ghosn, Nissan's chief executive. Nissan's Datsun relaunch had Ghosn's full support: He was born in Brazil and didn't own a car until his late teens. To Ghosn, Datsun represented more than a business strategy or business model. Much more, in fact: It was a life mission, a make-or-break, billion-dollar decision that would determine his legacy and his reputation. In 2007, Ghosn convened a cadre of company executives known as the Nissan Exploratory Team and dispatched members to India to study what consumers there sought in a car.

Industry observers noted that the Datsun nameplate was very popular in the United States in the 1960s and 1970s. In 1981, executives decided to unify the two brands, so Datsun became Nissan. The result: Much confusion among consumers and a gradual erosion of Nissan's market position in the United States. The move is widely regarded as one of the worst decisions in the history of the automobile business.

In 2012, Yukitoshi Funo, an executive vice president at rival Toyota Motor Corporation, expressed doubts about Datsun's prospects: "It's a big mistake to think you can introduce a cheap car in emerging markets and be successful. People want a car they and their families can be proud of." His remarks proved to be prescient. When Datsun launched in India in March 2013, Ghosn predicted that Datsun and Nissan would have a combined 10 percent market share in India by 2016. As it turned out, sales were below expectations. One issue was low brand recognition for both Nissan and Datsun. Also, only a few Datsun dealerships were opened, so Nissan dealers were recruited to carry the Datsun line. Consumers appeared to view Datsun as simply a stripped-down Nissan.

Discussion Questions

11-9. What is the key to the Logan's low price?

11-10. Do you think Tata will be able to save the Nano? Which steps should the company take?

11-11. Assess Carlos Ghosn's plans to revive the Datsun nameplate in India. Can a car that sells for $3,000 generate a profit for the parent company?

11-12. Low-cost cars such as the Nano and Datsun lack the multilayered safety and quality features required by regulators in high-income markets. Is it appropriate to create "bare-bones" cars with fewer safety features for emerging markets?

Sources: Simon Mundy, "Tata on Road to Recovery after Nano Disaster," *Financial Times* (March 13, 2018), p. 13; Santanu Choudhury, "Datsun's Second-Coming Sputters," *The Wall Street Journal* (February 12, 2015), p. B6; Henry Foy and James Crabtree, "Nissan Goes Back to the Future with Datsun," *Financial Times* (July 15, 2013), p. 16; Chester Dawson, "For Datsun Revival, Nissan Gambles on $3,000 Model," *The Wall Street Journal* (October 1, 2012), p. A1; Sebastian Moffett, "Renault's Low-Price Plan Turns Tricky," *The Wall Street Journal* (February 2, 2011), pp. B1, B2; Vikas Bajaj, "Tata's Nano, the Car That Few Want to Buy," *The New York Times* (December 10, 2010), p. B1; Simon Robinson, "The World's Cheapest Car," Time.com (January 10, 2008); Heather Timmons, "In India, a $2,500 Pace Car," *The New York Times* (October 12, 2007), pp. C1, C4; David Gauthier-Villars, "Ghosn Bets Big on Low-Cost Strategy," *The Wall Street Journal* (September 4, 2007), p. A8; John Reed and Amy Yee, "Thrills without Frills," *Financial Times* (June 25, 2007), p. 9; Christopher Condon, "The Birth of a Frankenstein Car," *Financial Times* (July 20, 2004), p. 12.

CASE 11-2
Global Consumer-Products Companies Target Low-Income Consumers

"Frugal engineering." "Indovation." "Reverse innovation." These are some of the terms that marketers at GE, Procter & Gamble, Siemens, and Unilever are using to describe efforts to penetrate more deeply into emerging markets. As growth in mature markets slows, executives and managers at many global companies are realizing that the ability to serve the needs of the world's poorest consumers will be a critical source of competitive advantage in the decades to come. Procter & Gamble CEO Robert McDonald set a strategic goal of introducing 800 million new consumers to the company's brands by 2015. Achieving this goal would require a better understanding of what daily life is like in, say, hundreds of thousands of rural villages in Africa, Latin America, and China.

Consider, for example, that two-thirds of the world's population—more than 4 billion people—live on less than $2 per day. This segment is sometimes referred to as the "bottom of the pyramid" and includes an estimated 1.5 billion people who live "off the grid." Such individuals have no access to electricity to provide light or to charge their cell phones. Often, a villager must walk several miles to hire a taxi for the trip to the nearest city with electricity—a trip that is costly in terms of both time and money.

This situation has provided an opportunity for companies to create innovative sources of renewable energy. Solutions include a small-scale, roof-mounted, Chinese-made solar power system that costs $80, underground biogas chambers that generate electricity from cow manure, and scaled-down hydroelectric dams that can power a village from a local stream or river.

One of the most pressing issues at the bottom of the pyramid is access to basic infrastructure. Historically, government-owned power-generation facilities, including massive solar projects and wind farms, have been the norm in emerging markets such as India. However, it is often not cost-effective to extend the power grid into rural areas. In fact, according to the International Energy Agency, fewer than two-thirds of the rural residents in the world's developing nations have access to electricity. One problem with the new renewable energy systems is the lack of scale. Rural markets are dispersed, and distribution is not well established. As a result, many investors consider rural renewable energy initiatives to be too risky to warrant funding.

This situation may be changing in Africa, where nearly 600 million people are included in the "off-grid segment." For years, small-scale organizations such as Solar Sisters have worked at the individual level to help provide renewable energy sources. Now large global companies such as Philips Electronics, DuPont, and Siemens are testing solar-powered systems at the village level. The companies hope that government officials will purchase the systems and bring power to rural areas. The systems include solar panels for charging batteries and overhead home lighting and lanterns that use efficient LEDs. As Philips has discovered in its pilot program in South Africa, the money that villagers save by not buying kerosene can be spent on necessities such as bread. If the pilot programs are successful and win government funding, enough power will be available to enable village households to have refrigerators and radios.

Lack of scale and a shortage of capital are just two of the problems associated with reaching the world's poor. For consumer products, Professor Aneel Karnani of the Ross School of Business has identified another stumbling block to market success. "The biggest problem is that prices are too high. Companies overestimate the size of the market and end up selling to the middle class, not the poor," he says. But there is a potential upside: Even as shoppers in mature markets cut back on discretionary spending, consumer spending on basic items such as food and soap remains stable and relatively unaffected by trends in the broader global economy. However, after companies have created the right product at the right price, another potential problem presents itself: communicating product benefits and persuading low-income consumers to change long-entrenched behaviors by paying for new products and integrating them into their lifestyles. In short, it is not enough to simply launch a low-cost product; markets for that product must be created.

Nestlé's experience in emerging markets illustrates how a painstaking approach can yield positive results. Indonesia is a case in point. As the data in Table 7-3 indicate, Indonesia is the world's fourth most populous country. Even though per capita income is only $3,400 per year, Nestlé Indonesia generates annual revenues of $1 billion. The company has enjoyed consistent sales growth for Milo, a chocolate sports drink mix for children. It can be prepared hot or cold and sells for about 10 cents per serving. Crunch, another new chocolate product, is a bite-sized snack wafer that also sells for 10 cents per package. Nestlé's food engineers managed to keep the cost low by using existing production processes utilized for the company's breakfast cereal lines. Because the Crunch packaging is inflated, the wafers don't melt or break into pieces.

Nestlé has also successfully targeted low-income consumers in Latin America. With a population of 207 million people and a gross domestic product (GDP) of $1.8 trillion, Brazil dominates the region. Per capita income is $8,840, placing Brazil in the ranks of upper-middle-income countries. But averages can be deceiving: Some 30 million Brazilians qualify as "bottom-of-the-pyramid" consumers, and an estimated 16 million Brazilians live on less than $600 per year. In the mid-2000s, the president of Nestlé do Brasil initiated a regionalization program. Ivan Zurita knows that Brazil's vast geographical territory means that brand preferences will vary from region to region. There is no "one size fits all," single consumer profile in the country.

For example, northeastern Brazil is the poorest region in the country. There, Nestlé launched Leche Ideal, a powdered milk mix enriched with vitamins and iron that is sold in 200-gram packets that are easy to store. In the Brazilian state of Bahia, Nestlé opened a new plant in 2007 that has the capacity to produce 50,000 tons of food products each year. Crucially, the products can easily be adapted to local tastes, such as a smoother-tasting coffee. The success of the regionalization program in Brazil has prompted Nestlé executives to call for its expansion throughout the region. Zurita is confident that Nestlé can leverage its experience in Brazil to launch similar programs in Chile and other Latin American countries.

Other well-known global marketers are also capitalizing on the opportunity to serve low-income consumers. For example, Kraft recently opened its first plant in northeastern Brazil. Adidas has developed a sneaker priced at 1 euro that it hopes to sell in Bangladesh. Unilever's Cubitos are seasoning cubes that sell for as little as 2 cents each. Danone has developed a variety of products for emerging markets, including Dolima drinkable yogurt, Dany Xprime jelly pouches, and Milky Start milk porridge.

Not every company has been successful in targeting the low-income segment. For example, Procter & Gamble spent years developing PUR, a water purification powder that sells for 10 cents. Although market research indicated that villagers wanted clean water, PUR ultimately did not catch on with consumers. In the end, P&G chose to donate PUR to relief organizations and partner with other groups to educate villagers about the benefits of PUR.

Even as Procter & Gamble continues to target consumers at the bottom of the pyramid, its primary target is the middle-class consumer: a professional manager who lives in a modern high-rise apartment building and has enough discretionary income to dine out several times each month.

Procter & Gamble has also learned the value of local research and development programs. This is something that domestic companies in India and other emerging markets have recognized for a long time. In fact, as innovation guru Vijay Govindarajan has noted, "The biggest threat for U.S. multinationals is not existing competitors. It is going to be emerging-market competitors." In India, for example, entrepreneurial companies are creating a variety of low-cost products that meet the needs and fit the lifestyles of consumers at affordable prices.

"Our innovation strategy is not just diluting the top-tier product for the lower-end consumer. You have to discretely innovate for every one of those consumers on that economic curve, and if you don't do that, you'll fail."

Robert McDonald, former CEO and chairman, Procter & Gamble

One of these products is an improved $23 wood-burning stove created by a startup company called First Energy. Indian women spend many hours each day cooking, and there was a clear need for a stove that burned less wood and generated less smoke. The key was adapting technology used in power plants. Engineers at the Indian Institute of Science created a high-efficiency, perforated burning chamber equipped with a small fan. The engineers also found an innovative way to convert agricultural by-products into valuable resources: The new stove burns pellets made from corn husks and peanut shells.

Hindustan Unilever spent 4 years developing Pureit, a portable water purification system that costs $43. Rather than rely on traditional distribution channels, Unilever tapped its network of 45,000 sales representatives who demonstrate Unilever products in their own homes. The women follow up the demonstrations by delivering products door-to-door. Today, more than 3 million Indian homes have Pureit systems.

Godrej & Boyce Manufacturing offers Little Cool, a $70 portable refrigerator that uses minimal electricity. Only 20 percent of Indian households have refrigerators; to assess the opportunity, Godrej sent researchers to meet with farm families in rural India. The resulting product resembles a cooler with handles for easy transport. Instead of a power-hungry compressor, the units have cooling chips and fans. Because power outages are common in India, Little Cool can run on batteries, and it is heavily insulated so contents stay cool for hours.

Discussion Questions

11-13. Why are companies such as Siemens, GE, Nestlé, and Procter & Gamble targeting the "bottom of the pyramid"?

11-14. Review the Chapter 4 discussion of diffusion theory. How might an understanding of the characteristics of innovations help marketers succeed in emerging markets?

11-15. Which types of marketing communications may be necessary to launch an innovative product such as Procter & Gamble's PUR in emerging markets? Which changes in consumer attitudes and behavior are required for successfully launching a product such as PUR?

11-16. Which key concepts discussed in Chapter 1 apply to Nestlé's experience in Latin America?

Sources: Heidi Vogt, "Made in Africa: A Gadget Startup," *The Wall Street Journal* (July 10, 2014), pp. B1, B6; Tio Kermeliotis, "'Solar Sisters' Spreading Light in Africa," *Marketplace Africa*, www.cnn.com (January 2, 2013); Eric Bellman, "Multinationals Market to the Poor," *The Wall Street Journal* (July 24, 2012), p. B8; Patrick McGroarty, "Power to More People," *The Wall Street Journal Report: Innovations* (June 18, 2012), p. R4; "Catching up in a Hurry," *The Economist* (May 19, 2011), p. 32; Jennifer Reinhold, "Can P&G Make Money in Places Where People Earn $2 a Day?" *Fortune* (January 17, 2011), pp. 58–63; Christina Passariello, "Danone Expands Its Pantry to Woo the World's Poor," *The Wall Street Journal* (June 25, 2010), pp. A1, A16; James Lamont, "The Age of 'Indovation' Dawns," *Financial Times* (June 15, 2010), p. 17; Elisabeth Rosenthal, "African Huts Far from the Grid Glow with Renewable Power," *The New York Times* (December 25, 2010), p. A1; Erik Simanis, "At the Base of the Pyramid," *The Wall Street Journal* (October 26, 2009), p. R6; Eric Bellman, "Indian Firms Shift Focus to the Poor," *The Wall Street Journal* (October 21, 2009), p. A1; Carlos Adese, "In Good Taste: Nestlé Tweaks Products for Different Parts of Brazil—and Latin America—to Boost Sales," *Latin Trade* (July 1, 2007), p. 6.

CASE 11-3
LVMH and Luxury Goods Marketing

LVMH Moët Hennessy–Louis Vuitton SA is the world's largest marketer of luxury products and brands. Chairman Bernard Arnault has assembled a diverse empire of more than 60 brands, sales of which totaled €42.8 billion (about $50 billion) in 2017 (see Figure 11-2). Arnault, whom some refer to as "the pope of high fashion," recently summed up the luxury business as follows: "We are here to sell dreams. When you see a couture show on TV around the world, you dream. When you enter a Dior boutique and buy your lipstick, you buy something affordable, but it has the dream in it."

Decades ago, the companies that today make up LVMH were family-run enterprises focused more on prestige than on profit. Fendi, Pucci, and others sold mainly to a niche market composed of very rich clientele. However, as markets began to globalize, the small luxury players struggled to compete. When Arnault set about acquiring smaller luxury brands, he had three goals in mind. First, he hoped that the portfolio approach would reduce the risk exposure in fashion cycles. According to this logic, if demand for watches or jewelry declined, clothing or accessory sales would offset any losses. Second, he intended to cut costs by eliminating redundancies in sourcing and manufacturing. Third, he hoped that LVMH's stable of brands would translate into a stronger bargaining position when managers negotiated leases for retail space or bought advertising.

Sales of luggage and leather fashion goods, including the 163-year-old Louis Vuitton brand, account for 30 percent of LVMH's revenues (see Figure 11-2). The company's Selective Retailing group includes Duty Free Shoppers (DFS) and Sephora. DFS operates "travel retail" stores in international airports around the world; Sephora, which LVMH acquired in 1997, is Europe's second-largest chain of perfume and cosmetics stores. Driven by such well-known brands as Christian Dior, Givenchy, and Kenzo, perfumes and cosmetics generate nearly 15 percent of LVMH's revenues. LVMH's wine and spirits unit includes Dom Perignon, Moët & Chandon, Veuve Clicquot, and other prestigious Champagne brands.

Despite the high expenses associated with operating elegant stores and purchasing advertising space in upscale magazines, the premium retail prices that luxury goods command translate into handsome profits. The Louis Vuitton brand alone accounts for approximately 60 percent of LVMH's operating profit. Unfortunately for the company, unscrupulous operators have taken note of the high margins associated with Vuitton handbags, gun cases, and luggage displaying the distinctive beige-on-brown latticework LV monogram. Louis Vuitton SA spends $10 million annually battling counterfeiters in Turkey, Thailand, China, Morocco, South Korea, and Italy. Some of the money is spent on lobbyists who represent the company's interests in meetings with foreign government officials. Yves Carcelle, chairman of Louis Vuitton SA, recently explained, "Almost every month, we get a government somewhere in the world to destroy canvas, or finished products."

Another problem is a flourishing gray market. Givenchy and Christian Dior's Dune fragrance are just two of the luxury perfume brands that are sometimes diverted from authorized channels for sale at mass-market retail outlets. However, LVMH and other luxury goods marketers found a way to combat gray market imports into the United States. In March 1995, the U.S. Supreme Court let stand an appeals court ruling prohibiting a discount drugstore chain from selling Givenchy perfume without permission. Parfums Givenchy USA had claimed that its distinctive packaging should be protected under U.S. copyright law. The ruling has meant that Costco, Walmart, and other discounters cannot sell some imported fragrances without authorization.

Opportunities and Challenges in Asia

Asia has long been a key region for LVMH and its competitors. For decades Japan was the number 1 market, but today China's luxury market exhibits the strongest growth (see Exhibit 11-8). The financial turmoil in Asia in the late 1990s and the subsequent currency devaluations and weakening of the yen translated into lower demand for luxury goods. Because price perceptions are a critical component of luxury goods' appeal, LVMH executives made a number of adjustments in response to changing business conditions. For example, Patrick Choel, president of the perfume and cosmetics division, raised wholesale prices in individual Asian markets. The goal was to discourage discount retailers from stocking up on designer products and then selling them to down-market consumers. Also, expenditures on perfume and cosmetics advertising were reduced to maintain profitability in the face of a possible sales decline.

FIGURE 11-2 LVMH Operating Units by 2017 Net Sales

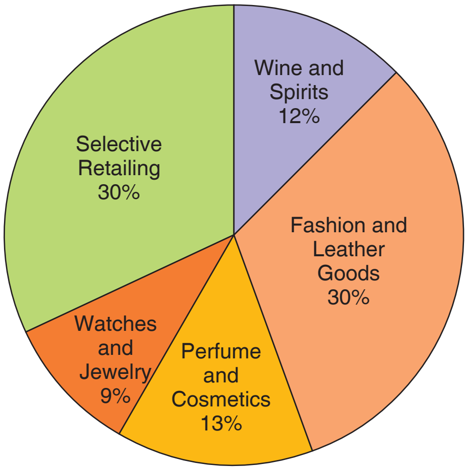


Exhibit 11-8 Louis Vuitton is opening flagship stores in Shanghai, Beijing, and other key cities in China.
Source: testing/Shutterstock.

"The big question for the future is, will the Chinese new entrant to the luxury market choose a Louis Vuitton as her first bag, as she has tended to do to date, or that of another brand?"

Antoine Belge, luxury goods analyst, HSBC

Strategic Decisions at LVMH

Over the past decade, Arnault has leveraged his multibrand strategy by broadening the company's consumer base. In the late 1990s, Arnault sensed that cosmetics-buying habits were changing in key markets. He opened Sephora stores in New York, Chicago, and San Francisco in conjunction with a new Web site, Sephora.com. Today, there are more than 270 Sephora stores in the United States and Canada; the chain also has a presence in more than a dozen other countries, including China and Russia. Customers who visit Sephora USA stores are encouraged to wander freely and sample products on an open floor without waiting for sales clerks to assist them.

In 2001, Arnault paid more than $600 million for Donna Karan International and its trademarks. Arnault had tried without success to acquire Giorgio Armani; Donna Karan is LVMH's first American designer label. As Arnault noted, "What appealed to us is the fact that it is one of the best-known brand names in the world."

In January 2008, executives at Louis Vuitton announced a new corporate branding campaign using a 90-second ad slated to appear on cable and satellite television and in cinemas. This was something new in the luxury goods sector; generally, advertising budgets are limited and television time is viewed as too expensive. In addition, some in the industry believe that TV's status as a mass-marketing medium can undercut a luxury brand's aura of exclusivity. For Louis Vuitton executives, the hope was that audiences would connect with the brand's travel heritage. To achieve that connection, the company's ad agency proposed buying time on news channels that business travelers watch such as CNN. As Louis Vuitton marketing chief Pietro Beccari noted, "It is supposed to touch our clientele and viewers in ways that perhaps other media will not touch. This is a way to say Louis Vuitton is different. It is something *éphémère*, but also something that stays."

Arnault has also turned his attention to emerging markets. Louis Vuitton entered India in 2002 with a boutique at a luxury hotel; now, Fendi, Tag Heuer, and Dior are open for business in that country as well. LVMH has a lock on prime locations at Emporio, an upscale shopping mall that opened recently in New Delhi. Because LVMH has a group presence in the mall, it can negotiate favorable lease rates for retail space. Arnault's expansion coincided with the September 2007 launch of *Vogue India*. Once again, thanks to LVMH's diverse brand portfolio, the company is able to buy large blocks of advertising space from the magazine's owner, Condé Nast India, at discounted prices.

The global economic crisis that gained traction in 2008 affected many retail sectors, and the luxury goods business was no exception. Overall purchases of luxury goods fell in the key U.S. market; sales slowed in Russia and other emerging markets as well. Although total sales in the luxury segment were expected to reach a record €175 billion ($218 billion) in 2008, industry observers expected the sales to drop significantly in 2009. For European-based luxury companies, there was some good news: The dollar was strengthening against the euro. As the 2008 holiday shopping season approached, many luxury goods makers reduced prices in the United States. At Chanel, the cuts ranged from 7 to 10 percent; as John Galantic, president of Chanel's U.S. unit, noted, "The dollar's recent strength has allowed us to pass on greater value to our customers." Louis Vuitton was a notable exception; during 2008, the company raised prices twice, resulting in an average increase of 10 percent. The price increases did not dampen sales; in fact, sales continued to increase.

Visit the Web Site

www.lvmh.com

A complete PowerPoint presentation of the current year's financial results is available on the LVMH Web site.

www.sephora.com

Discussion Questions

11-17. What were the possible risks of Louis Vuitton's first-ever television advertising campaign?

11-18. In fall 2011, the euro/dollar exchange rate was €1 = $1.35. By spring 2015, the dollar had strengthened to €1 = $1.10. Assume that a European luxury goods marketer cut the price of an $8,000 linen suit by 10 percent when launching its spring 2015 collection. How would revenues have been affected when dollar prices were converted to euros?

11-19. Louis Vuitton executives raised prices in the late 2000s, and sales continued to increase. What does this say about the demand curve of the typical Louis Vuitton customer?

11-20. Compare and contrast LVMH's pricing strategy with that of "accessible luxury" brands such as Coach.

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12 Global Marketing Channels and Physical Distribution

LEARNING OBJECTIVES

12-1 Identify and compare the basic structure options for consumer channels and industrial channels.

12-2 List the guidelines companies should follow when establishing channels and working with intermediaries in global markets.

12-3 Describe the different categories of retail operations that are found in various parts of the world.

12-4 Compare and contrast the six major international transportation modes and explain how they vary in terms of reliability, accessibility, and other performance metrics.

CASE 12-1
Welcome to the World of Fast Fashion

The world of global fast-fashion is like a three-way horse race. Spain's Inditex SA is the parent company of specialty retailer Zara; Sweden is home to Hennes & Mauritz AB, better known to shoppers as H&M; and Uniqlo is the flagship brand of Japan's Fast Retailing.

Part of the appeal of fast fashion is the low prices. Also attractive is the speed at which inventories are replenished and updated with affordable versions of the latest runway trends from the world's fashion capitals. The need for speed is fueled in part by social media. A key element for some fast-fashion brands is sourcing clothing from countries with low-cost labor in Asia and elsewhere. In Cambodia, for example, more than 400 garment factories are registered exporters.

However, some industry observers note that low prices actually carry high social and environmental costs. Chasing the latest trends means that shoppers often discard inexpensive garments after wearing them just a few times. This leads to a consumer mindset that clothing purchases are disposable, rather than long-term investments. Critics assert that unwanted clothing often ends up in landfills, and that the fast-fashion trend is not sustainable (see Exhibit 12-1).

For years, Tadashi Yanai, the founder of the Uniqlo ("Unique Clothing") chain, pursued a business model that differentiated his company from its European rivals. Uniqlo's focus was on everyday basics and a new-product development process that relied heavily on innovative materials.

Inditex is the world's largest fashion retailer, with more than 7,000 stores in 92 countries. In addition to Zara, its brands include Bershka, Pull & Bear, and Massimo Dutti. The company does not advertise, and its motto is "The company doesn't speak; the customer speaks for the company." Unlike some of its competitors, Inditex keeps nearly two-thirds of its production in Spain or neighboring countries.