Chasing Shadows

Pursuing Counterfeiters is Costly but Ultimately Effective

By Hans Joachim Fuchs and Zhou Shuqin

The costs of combating counterfeiting are high, ranging between six and eight digit sums depending on the size of the company in question: For management and patent protection, trademarks, copyrights, as well as for infringement suits. As a result, managers and executives are increasingly questioning not only the effectiveness but also the efficiency of such actions. Will the expenses really pay off, i.e. are the costs for protecting intellectual property (IP) and for prosecuting infringement cases reasonable with regard to the damage prevented?

Costs of Protection vs. Damage Prevented

Basically, IP protection costs in the long run have to be significantly lower than the damage caused, for instance, by loss due to IP theft by counterfeiters. The cost-benefit ratio of IP protection is best illustrated with the example of product and trademark piracy, because it is possible to quantify the damages caused by counterfeiting. In contrast, this is not true for other areas of IP infringement such as industrial espionage.

The monetary damages suffered by original manufacturers due to product and brand piracy consist of several components.

Short-term Damages

In the ongoing fiscal year, counterfeits entail a direct loss in turnover, since many potential buyers deliberately turn down the original product and buy a copy instead. In addition, cheap fakes put pressure on the price of original products. In China, Western engineering companies were forced to reduce their prices by up to 20-25 per cent to stay competitive with their Chinese counterfeiters. That means that there is often a massive short-term loss in profit due to price pressure.

Medium-term Damages

Counterfeiters copy one another. As a result, there is a snowball effect that very quickly entails large secondary markets and cheap counterfeit products. These competitive, cheap markets slowly but surely undermine the original manufacturers' turnovers. Thus, the essential problem for manufacturers is not the current loss in turnover resulting from the counterfeits presently offered for sale in international markets. Their major problem is the future cumulated loss of market share and, thereby, of turnover and cash flow caused by the growing cheap markets and their counterfeit products damaging businesses and possibly even ruining them.

Long-term Damages

Continuous counterfeiting entails damage to the original brand, or rather the reputation of the original manufacturer, because his trademark is steadily degraded by down-trading. If that is eroded, then brand value decreases. Further damage possibly results from compensation payments if original manufacturers are made liable for defective counterfeit products. The costs caused by such cases are either noted within the company or can be easily identified.

Costs of IP Protection

Intellectual property rights (IPR) protection costs and the prosecution of IPR violators can easily be calculated through individual expenditure items. However, costs may be reduced if the company receives compensation from successful IP law suits, which is increasingly the case. Six-figure compensation payments are not uncommon in successful infringement cases.

Calculating the Damage

The total damage arising for a company due to counterfeiting is calculated by adding together the short-term, medium-term, and long-term damages as well as compensation paid or as yet to be paid.

The results of such calculations show that losses from IP infringement can be ten-fold higher than the costs of IP protection. But how can the separate components of the damage be calculated?

Formula for Calculating the Cost-Benefit Ratio of IP Protection

[Costs for protection in the period (to-tx) minus compensation] << [Current loss in turnover] + [Loss in market share] + [Brand damage] + [Liability]

Source: Chinabrand Consulting

Calculating the Short-term Losses in Turnover

Short-term losses of turnover that result from product and brand piracy can be traced through experiences of the industry, projections of individual companies, noted cases, and the turnover of identified counterfeiters.

- Calculation through industry values
  According to a survey by the German engineering federation VDMA, German machine builders lose an average of three to five per cent of their yearly turnover due to product and brand piracy. In a company with a yearly turnover of USD 1 billion this would mean a loss of USD 30 million to USD 50 million per year.

- Projective calculation of individual cases
  Dark figure losses are calculated by IP infringement cases identified through evidence, inspections, or customs controls. Depending on the industry in question, such measures can only identify between one-sixth and one-tenth of total infringements. Therefore, the value of seized goods from a factory should be multiplied by a factor of six or ten to calculate loss of turnover for the original manufacturer.

- Calculation through counterfeiters' sales
  Although the total amount of imitations made by a single counterfeiter is generally not known, total loss to an original manufacturer can be calculated through the turnover of the counterfeiter. However, it is important here to take into account consumer behaviour as well as the price difference between the original and the counterfeit.

The current loss in turnover at a point in time (eg, in the year 2010) is calculated indirectly via the counterfeiters' turnover: Earnings of the counterfeiter equal the loss of the original manufacturer. A price determinant indicates the ratio of fake price to original price on the market. For a ratio "copy – original = one – five", the price determinant is five, i.e. the original producer's loss is five times as high as the counterfeiter's profit.

The effect of a counterfeiter on a brand or product is calculated through their leverage and the impact this leverage has on consumer behaviour. For a brand like Rolex, the leverage is likely to be close to zero as copies are not considered to be equivalent substitutes for originals. No fake buyer will purchase an original Rolex watch and no well-off Rolex buyer will switch to an imitation. On the other hand, in the case of frequently copied fashion labels like Polo Ralph Lauren an estimated leverage factor of 0.2 to 0.3 applies. For producers of perfect fakes – those that cannot be distinguished from the original and deceive the customer – a levering factor of one is applicable.

One knock-on effect is a reduction in variable costs due to lower production. A company selling less due to fakes produces less.

Lost Market Share

The medium-term damage due to lost market share is calculated with the net present value or discounted cash flow, i.e. the cash value at the present time. Through the permanent loss of market share due to quickly growing secondary markets, cumulated loss of cash flow arises over a certain period of time and reaches very high levels over the years. Damages that occur at different, later points in time are not equivalent in relation to the present moment.

In order to evaluate the cash value of possible future damage, the capital cost rate (CCR) is applicable, which is normally higher than the interest rate for outside financing as it takes into consideration the opportunity costs of the invested capital. The CCR is the minimum rate of return that a company should generate. Normally, the CCR is not suitable for discounting losses. When it comes to evaluating the profitability of an anti-counterfeiting operation, the assessment is the same as that of an investment project. The decrease of losses in turnover or cash represents the profit due to the investment.

As an example, an American brand suffered a permanent loss of market share between August 1995 and May 1998 in China. While the brand's market share assessed by market research apparently remained nearly unchanged, deliveries of the original brand to Beijing steadily decreased. This means that over the years original products were increasingly superseded by counterfeits.

Brand Damage

Through the extensive spread of counterfeited products and copied trademarks, the original brand is continually weakened within the market, causing long-term damage. It loses its exclusiveness and attraction, and that significantly lessens its monetary value over time. Since leading brands are often highly valued, even small damage factors of a few per cent already have relatively strong monetary effects. The damage factor has to be estimated.

One notable case is that of Polo Ralph Lauren. Once a premium brand, the massive flood of low quality fakes onto the

China market has lowered its brand value by ten per cent. Today, the brand is regarded as mainstream.

Brand value can be calculated through different methods, most commonly those devised by Interbrand, an international brand consultancy. The damage factor is industry- and company-specific and varies between five and 30 per cent. Various brand rankings also provide general criteria for potential losses in brand value.

A Worthwhile Pursuit

Losses that result from counterfeits are commonly noted by companies and can be incorporated into the calculation of the total damage as a fixed position. However, many firms still do not recognise the positive cost-benefits of pursuing IPR protection. That is a serious miscalculation.

Thankfully, there is a growing understanding that the evaluation of underestimated immaterial capital – especially in form of intellectual property rights – is playing an increasingly important role in commerce. There is no single way to calculate losses from counterfeiting, but that does not mean that it does not heavily impact on foreign companies operating in China. Companies need to pay more attention to the problem, understand its complexities, and then enact relevant anti-counterfeiting measures to protect their brand and continue to grow in China. ■

Profile

CHINABRAND CONSULTING is a German management consulting firm, focused on the business of Western brand companies (B2B and B2C) in China. We advise European, US, and Asian companies, experienced in China, in demanding projects regarding market, competition and intellectual property. CHINABRAND also acts as supervisor and surveyor. CHINABRAND concentrates on market and competitive intelligence, competitive and brand strategy, M&A, innovation and IP management, protection of know-how/intellectual property, and anti-counterfeiting. The firm runs offices in Boston, Munich, and Shanghai and employs highly qualified consultants with years of experience. Our clients are famous brands from various industries, eg, pharmaceuticals, mechanical engineering, electronics, consumer goods, fashion, media, and healthcare.


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