



The Cost of Counterfeits

Janice H. Nickel, Henry Sang, Jr.
Digital Printing and Imaging Laboratory
HP Laboratories Palo Alto
HPL-2007-133
August 9, 2007*

wine, counterfeiting,
anti-counterfeiting

Counterfeit goods are having a huge impact on world wide economic health. Accurate estimates on the international counterfeit market are difficult to come by, as counterfeiting is an inherently clandestine process. It is clear however that counterfeiting is reaching into all industries where a profit can be made. The wine industry depends on brand value to command a premium price, which constitutes a prime objective for counterfeiters. Counterfeit wines, not only of premium vintages but also of more modestly priced varieties, have been exposed. We discuss the potential losses to the wine industry, the lure of the premium wine market to counterfeiters, as well as possible actions the industry can take to deter counterfeits.

* Internal Accession Date Only

Approved for External Publication

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Janice H. Nickel, Henry Sang, Jr.
Hewlett-Packard Laboratories, Palo Alto, CA 94304

Wine, as with many other products, is becoming a target for counterfeiters. In the globally connected world today, any item that commands a premium price by virtue of brand value can be, and generally is, subject to counterfeiting. To deal with this problem, one needs to understand the risks and costs to the winery and its brand presented by the counterfeiting threat.

The wine industry can learn much from efforts in other industries to fight fraud. Hewlett-Packard Company fights to deter counterfeit printer cartridges, computer disc drives, and memory chips on a daily basis. Hard alcohol and printer cartridges are counterfeited by both large and small scale operations using refilled containers. Toys, DVDs, cigarettes, and handbags are regularly attacked with 100% knock-off goods. Today, there are even dedicated conferences where manufacturers discuss best practices.

Wine is a relatively easy mark for potential counterfeiters. Packaging is mostly distinguished by a label and a cork. Identification by taste requires knowledge and experience of the product; in fact, taste variation is expected based upon aging, handling and storage conditions. Business-wise, it is a product with increasing global demand, high profit margins, and high brand value. With so many different wines all vying for a market position, it is easy to hide because of consumer confusion.

The frequency of the fraud, players and methodologies used to create and deliver counterfeit wine will differ with market categories. The scam used for a truckload of \$20 bottles of wine is significantly different than what is used to counterfeit two cases of a 15 year old, \$1000 bottles being sold at auction.

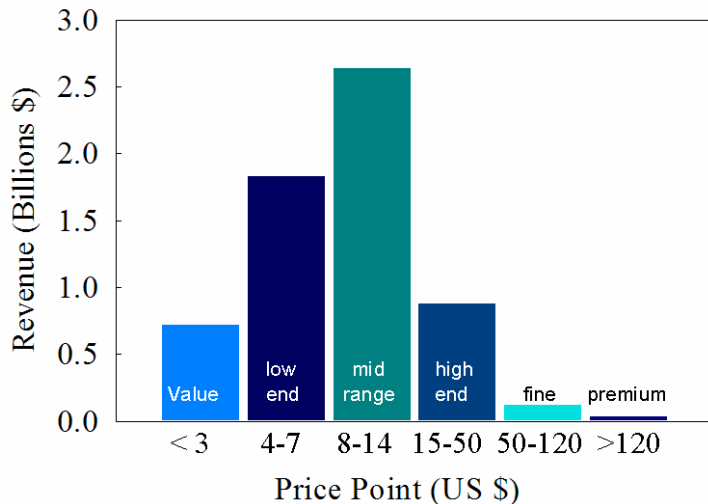


Figure 1: Revenue derived from the California wine industry as a function of the price point of the product¹.

For the purposes of fraud analysis, the market can be categorized into segments based on the price point of the product. The categories we delineate are value (<\$3), low (\$4-\$7), mid (\$8-14), high (\$15-50), fine (\$50-120), and premium (\$120-1000). Rare or trophy wines of older vintages of particularly exceptional premium wines can command a significantly higher price.

Figure 1 gives an estimate of the size of each of these market segments for the California wine industry. The revenue is in billions of US dollars, as a function of price point at time of release¹.

A sensational news article about counterfeiting of trophy wines gets much attention because of the audacity of the crime on a per bottle basis, and the deception of professionals². However, history teaches that most counterfeiting is done by hiding significant volumes of bogus product in a thriving market. Much of this goes undetected, and yet can seriously compromise a company and its brand.

Potential Losses

Losses come from both direct and indirect costs. Counterfeiting reduces revenues for the authentic producers and distributors, lowers the brand quality in the eyes of the consumer, and it exposes the producer to liability risks. There are also ancillary costs associated with fraud prevention, audits and investigation, time spent with regulators and customs, pressure from legitimate distributors, and increased customer service costs. One of the first tasks in addressing fraud is to do a full spectrum loss analysis.

The most obvious threat is lost revenue to the winery. If the wine is supply limited, the winery will still sell its entire product, however it is possible that future sales may be affected by competition from counterfeit supplies and reduced pricing options due to loss of brand. When sales or pricing are demand-limited, counterfeits cause direct loss of revenue often through lower prices or decreased profit due to increased promotional costs.

Brand damage is very serious. Wineries spend significant marketing dollars to establish their brand image. The brand value in awards, independent evaluations, and personal recommendations is critical to establishing a market presence. When a customer buys a counterfeit product of significantly reduced quality, the customer might no longer buy or recommend the product. Even reading of an issue with counterfeits is enough to create uncertainty and doubt in the buyer's mind.

Ironically, these events are interconnected, because counterfeiters preferentially target brands that have an established and desired brand with a thriving business. A supply limited brand drives up the competition for product and retail buyers are often happy to make a purchase at a slightly reduced rate – creating an entry point to inject counterfeits into the distribution chain.

Increasingly, counterfeiting may even present a liability to the producers, as toxic materials may be incorporated in the counterfeit product. Diethylene glycol (DEG), a chemical used in antifreeze, had been found used in small amounts in one wine as a sweetener³. DEG was recently found in counterfeit Colgate toothpaste, causing multiple deaths in South America, and health issues in the United States⁴.

While a company can not be held responsible for a counterfeit product, they can be open to liability due to negligence if they know about an existing health threat to the consumer,

and do not actively seek to inform and protect the public. Disclosure of toxic or harmful chemicals in a counterfeit product could be catastrophic to a winery's reputation, and affect sales far past the counterfeiting incident.

The indirect costs such as working with regulators, participating in industry efforts, doing investigations, legal and fraud consultation, and educational efforts can be considerable. These jobs require skills not usually found in a winery, which typically result in the need to hire additional high cost employees, consultants and contractors.

Environmental factors conducive to fraud

Conditions are creating a favorable environment for wine counterfeiters. These include rapidly increasing global demand, higher prices associated with brands, and consumers who are not adept at detecting a fake.

Increased global demand is fueled by perceived health benefits, the recovery of traditional Asian markets, the emergence of new Asian and Eastern European markets, and the development of investment funds in fine wines. The increased demand of high-end, fine and premium wines, in conjunction with limited supplies, is driving up the price point of those segments.

Studies promoting drinking red wine for health benefits are causing wine to displace hard liquor in many Asian markets^{5,6}. The Chinese government has educational campaigns promoting the health benefits of red wine, and promotes the Western elitist practice. "Wine is seen as a part of a socially and culturally sophisticated lifestyle that once affordable, should be indulged in"⁶. Wine consumption is based on product reputation, and wine purchasing practices reflect its position as a status symbol.

The recovery of traditional Asian markets from the 1997 - 1998 financial crash is contributing to this growth. Japan, Hong Kong and Singapore are increasing their consumption to pre-crash levels: Singapore's wine imports have increased almost 100% in 2005 compared to 2001 [ref.7]; and Hong Kong saw a 21% increase in volume in 2006, nearly hitting the record set in 1997 [ref. 8].

New markets in India, Russia, and China have created hyper-growth over the last five years. Wine is becoming a fashionable drink, a health choice, and a status symbol for those who are now able to afford it. New consumers, with new wealth, have very little experience or knowledge of wine. While endeavoring to emulate the luxury Western custom, the palate is not developed, and there is ignorance on how the wine is expected to taste. This confluence of events creates a ripe opportunity for counterfeiters.

India's wine consumption is estimated to be "growing at 25-30 per cent a year"⁹. Much of this demand will be met with imports. EU exports to Russia have increased 237% between 2000 and 2005. Significantly, over this same period, EU exports to China have increased only a modest 27% (less than 2% annually)¹⁰, despite an estimated growth in demand for imported wines of 30% annually¹¹ (or 371% increase over 2000-2005). The

lack of an increase in EU exports to China commensurate with that to Russia is likely due to counterfeiting.

Another pertinent recent development is the establishment of wine investment funds¹² starting in the early 2000's. The funds buy "trophy wines" and hold these for profit. The funds serve to increase the value of their assets and the fine wine prices also increase to fill the void.

Production of fine and premium wines has not kept up with the increase in demand, driving up prices. Fine and premium wines are made in small lots, for example, Chateau Lafite Rothschild produces only 15000-25000 cases per year. The output of the small wineries producing the best wines is relatively stagnant. The trend for large conglomerates to buy small wineries, and then impose cost saving procedures which produce inferior wine, further reduces the supply of high end product¹³.

The result is that the values and prices of fine wines are increasing at a brisk pace, and reaching record levels – the futures for the 2005 vintage Chateau Lafite Rothschild are selling for \$840.00 for a 750 mL bottle¹⁴. This valuation increase at the extreme high end propagates down the supply chain, increasing the prices of second tier fine wines as well.

The hyper-growth of a market of relatively unsophisticated consumers, combined with the increased prices commanded by the wine, creates a ripe environment for the counterfeiter.

Counterfeiting across the spectrum

Anecdotal evidence indicates that counterfeiting is now occurring. Since the activity is illicit, discovery of even small amounts of counterfeiting indicates that substantially more is actually occurring. Counterfeit bottles of trophy vintages of Premier Grand Cru wines get sensational press, but counterfeiting occurs across price points from premium wines down through the mid-range wines.

Fraudulent bottles of trophy wines, by the nature of the product, are limited to one or a few bottles. Forgers often use genuine bottles, refilled with inferior wine. These are sold from "private cellars", often at auction. Experts estimate that 5% of the rare vintages sold on the secondary market are counterfeit¹⁵.

Awareness has caused auction houses to closely scrutinize wine bottles to determine its authenticity – sleuthing out the provenance; inspecting the bottle, cork, and capsule; and observing the wine's color, fill level and sediment accumulation. For wines sold through normal distribution channels, there are no experts the consumer can rely on to verify the authenticity of the product.

Serious counterfeiters are business people who are building an on-going and growing business, not those doing one-shot deals. These are the persons that can do the most damage to a wine producer. They will methodically create counterfeit products for many years.

The fine wine market has been the target of such counterfeiters. In 1998 fake bottles of the Australian winery Penfolds Grange famous 1990 vintage were discovered¹⁶. In Italy 16,000 counterfeit cases 1994 and 1995 Sassicaia – worth over £1 million – were seized¹⁷. An ongoing scam importing fake Rioja wines – estimated at one million bottles – was uncovered in 1999. In August 2007, police broke up a cross-border fraud where table wine was being sold as premium Italian wine¹⁸. Wines from the Georgia province of the former Soviet Union have been heavily counterfeited, and the resultant health hazard has been the proclaimed reason Russia has banned Georgia wine imports.

Canadian Icewine is popular in Taiwan and China, and it is estimated that up to 50% of the Icewine sold in these markets is fraudulent; Vineland Estates lost 95% of its Icewine sales to China to counterfeiters over a five year period¹⁹.

When done in volume, even mid – range priced wines are attractive targets for counterfeiters, 12,000 bottles of Mouton Cadet were uncovered by authorities in China¹⁹. The USDA Foreign Agricultural Service has listed “Counterfeiting and IPR [Intellectual Property Rights] violations in China” as the top threat for exporting wine to Shanghai²⁰.

Taking Action

The industry would benefit by efforts from its trade and professional associations to formally address this type of growing fraud. Such efforts might include providing education, fraudulent event assistance, investigational teams, law enforcement support funds, and shared industry standards and techniques. Otherwise, if hundreds of uncoordinated approaches are undertaken, it will likely be less effective and much more expensive.

Companies and industrial associations need to methodically address the problem by taking stock of the problems and their real costs, creating programs to aid in detection of counterfeits, and to work with law enforcement to seize counterfeit product and to shutdown the counterfeiting facilities. Much can be learned from other industries and experts who are fighting these problems.

Producers will then need to protect themselves by adopting techniques to thwart would-be counterfeiters, and this is best done before it is a crippling problem. Consumers of this market will need to be educated as to how to determine the authenticity of the wines they are purchasing.

A word of caution – legal recourse can be difficult. The Canadian vintner, who lost 95% of its sales to China due to counterfeiting, started legal proceedings against the counterfeiters. Three years later, they received a letter indicating that the case is “on the docket for review in 2011” [ref. 19].

¹ Jane Firstenfeld, Premium Growth Trend For California Wine Continues, Wines and Vines, June 2007; the proportions of wines in the segments above the \$15.00 price point are estimated by the author and Prof. Douglas Brown, Georgetown University, Department of Economics.

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- ² See for instance: “Wines sold as rare may be fake”, CNNMoney.com, March 6, 2007.
- ³ “Some wine to break the ice”. *Lancet* **2** (8449): 254(1985).
- ⁴ “Colgate Says Fake Toothpaste Found in 4 U.S. States”, Reuters, June 14, 2007.
- ⁵ USDA Foreign Agricultural Service, Global Agriculture Information Network (GAIN) Report Number HK7005, p.3 (2007).
- ⁶ USDA Foreign Agricultural Service, GAIN Report Number CH6416.
- ⁷ “Wine for Asia 2006”, Pro-Wine: <http://www.pro-wine.com/news/event.php?id=200>.
- ⁸ USDA Foreign Agricultural Service, GAIN Report Number HK7005, p.1 (2007)
- ⁹ Seth Associates: http://www.sethassociates.com/wine_import_india.php.
- ¹⁰ European Commission, Agriculture and Rural Development, July 19, 2006:
http://ec.europa.eu/agriculture/markets/wine/facts/trade_partners.pdf.
- ¹¹ China Wines Information Website: <http://www.wines-info.com/html/189/20067311110421.html>.
- ¹² See for instance: <http://www.wineinvestmentfund.com>.
- ¹³ Prof. Douglas Brown, Georgetown University, Department of Economics, personal communication.
- ¹⁴ <http://www.wallywine.com/s-766-2005-bordeaux-futures.aspx>
- ¹⁵ M. Frank, “Counterfeit bottles multiply as global demand for collectible wine surges”, *Wine Spectator*, pg 14, Jan 31-Feb 28, 2007.
- ¹⁶ Martin Field, “Counterfeit Grange”, http://www.stratsplace.com/martin/counterfeit_grange.html.
- ¹⁷ Andrew Caillard MW, “Wine Investment – Swim between the flags”,
<http://www.langtons.com.au/Magazine/Features.aspx?MagazineID=88>, 2006.
- ¹⁸ Maggie Rosen, “Police uncover Italian wine fraud”, *Decanter.com*, August 23, 2007.
- ¹⁹ “Chateau Faux”, Brendan Coffey, *Forbes.com*, June 19, 2006.
- ²⁰ USDA Foreign Agricultural Service, GAIN Report Number CH6809, p. 9.