
Chazen Society Fellow Interest Paper

From Cartel to Competition: The Evolution of the Global Diamond Industry

KARTIK DHARMADHIKARI MBA '08

While a diamond might be forever, the diamond cartel clearly is not. The diamond industry, which for many years was dominated by the South African De Beers cartel, has undergone tremendous change over the last two decades and now faces an uncertain future. A host of exogenous and endogenous factors continue to compel De Beers, and the diamond cartel it helped forge, to make substantive changes to the business model under which it operates. Driven in large measure by the emergence of new, vertically integrated industry players, changing sets of priorities for mineral-rich countries, sociopolitical issues related to the diamond trade and the emergence of natural diamond substitutes, the diamond cartel as it has existed for the better part of the last century is becoming a historical relic. What lies ahead for De Beers will be determined in large part by a number of external factors currently affecting the diamond industry along with internal changes in De Beers's own strategy.

The discovery of diamonds near the Orange River in South Africa in 1867 ushered in the beginnings of the modern diamond industry. Until that point, organized diamond mining had yet to develop, and the scarcity of diamonds discovered in river beds helped to support high prices. The newly discovered mine in South Africa was far more productive in producing diamonds than any other source to date and forced the miners to grapple with the issue of excess diamond supply from the mine pushing down the price of diamonds on the open market. As a result, early investors such as Cecil Rhodes and Ernest Oppenheimer helped to form the De Beers Consolidated Mines, an entity with far-reaching control and influence over the mining and distribution of rough diamonds for jewelry.

The creation of De Beers was driven in large part by the need for cooperation among diamond producers to ensure that supplies were kept artificially low in order to support higher

prices. If excess supplies of diamonds hit the open market, De Beers would arrange to purchase these excess quantities directly from diamond producers and hold the diamonds in inventory, only releasing the stones once supply slowed. In doing so, De Beers controlled supply and provided benefits, in the form of higher prices, to all participants in the diamond industry, including diamond miners, wholesalers, polishers, cutters and retailers. As such, De Beers served the industry as buyer of last resort, essentially soaking up excess diamond supply on the market through purchases and bilateral agreements directly with global diamond producers. While this role required De Beers to make substantial and aggressive financial commitments in order to purchase diamonds produced outside its own diamond producing mines, the benefits of overall higher diamond prices, at least as seen by De Beers and other participants in the diamond trade, outweighed these costs.

To further facilitate supply control, in the 1930s De Beers formed the Central Selling Organization (CSO), a London-based group whose mandate was to intermediate between the extraction of diamonds from mines and the distribution of stones to diamond polishers and cutters. The CSO selected sightholders, or certified buyers, who would travel to London every five weeks to purchase an assortment of rough diamonds from De Beers at predetermined prices. Sightholders, the only people who could purchase rough diamonds from De Beers, were not allowed to negotiate price or supply.

Historically, De Beers dealt primarily with African nations to source diamonds. Diamonds were mined throughout various parts of sub-Saharan Africa, with Botswana, South Africa, Angola and Namibia accounting for the majority of production. Over the last 30 years, however, De Beers's firm grasp on supply has been shaken by the discoveries of substantial diamond deposits in other parts of the world, namely, Russia, Canada and Australia. In fact, according to De Beers's estimates, over 30 percent of the world's rough diamond supply in 2006 came from non-African nations.

De Beers has been slow to move in diversifying supply sources and is seeing such previously laggard diamond-mining rivals as Rio Tinto and BHP Billiton capitalize on newly discovered mines. With the majority of its rough diamonds still sourced in Africa, De Beers has seen its share of global rough diamond production from its own mines slip from 45 percent in the late 1990s to approximately 40 percent in 2006. Surprisingly, overall diamond market supply by the De Beers cartel slipped from over 80 percent in the mid-1990s to 45 percent in 2006. These changes are strong indications of De Beers's increasing irrelevance as a market regulator in today's modern diamond trade.

Although this precipitous drop is partly attributable to the defection of certain diamond producers from the De Beers cartel, the gradual shift by De Beers from a supply-driven business model to one more focused on demand has also played a significant role. To that end, in the late 1990s De Beers began to slow its purchases of excess diamond supply on the open market, a move induced largely by its own deteriorating financial situation and growing external pressures from regulators and antitrust authorities. In doing so, De Beers began the process of reducing its inventories of rough diamonds and extricating itself from its longtime role as a market regulator. Furthermore, in an effort to spark demand, De Beers began developing De Beers-branded diamond products and also launched a retail joint venture with LVMH, the French luxury-goods group. De Beers continues to invest heavily in marketing efforts. In 2006 alone, De Beers spent approximately \$200 million on marketing. However, De Beers now primarily supports only its own brand through marketing, not the industry as a whole as before.

De Beers also has to contend with new, vertically integrated competitors such as Israeli entrepreneur Lev Leviev. A former De Beers sightholder, Leviev branched out from diamond polishing and cutting and ventured further upstream in the diamond value chain, striking deals with the Russian, Angolan and Namibian governments to source diamonds directly from their rich deposits. Leviev created hundreds of jobs in these countries by relocating cutting, polishing and sorting facilities, a move designed to help secure these deals by appeasing governments interested in ensuring that a greater proportion of the diamond trade stay within their respective borders.

De Beers also continues to face significant bad press stemming largely from public outrage over the issue of conflict diamonds, stones that are mined in war-ravaged areas and whose proceeds have been used to fund armed conflict and civil strife in Africa. As the longtime face of the diamond industry and as the industry's buyer of last resort, De Beers periodically has been implicated by human rights groups and foreign governments as a tacit participant in the funding of armed conflict throughout Africa. In spite of joining the Kimberly Process, which mandates certain protocols to ensure that diamonds are not sourced from conflict zones, De Beers continues to face criticism for not doing enough to stop strife and violence in regions of the world in which it conducts business.

In addition to this full suite of existing market challenges, De Beers faces a far different, and perhaps more damaging, challenge from an unlikely source—developers of synthetic diamonds. In Sarasota, Florida, Clark McEwen is betting that his company, Gemesis, can produce diamonds nearly identical to those of De Beers for a fraction of the cost. The difference is that these diamonds are produced in a machine over the course of two to three days, not by nature over the

course of several million years. Bryant Linares of Apollo Diamond, another synthetic diamond manufacturer, claims that within a decade synthetic diamonds could account for close to 20 percent of the U.S. diamond jewelry market. This estimate at a minimum indicates the growing and perceived threat that synthetic diamonds pose to the status quo in the diamond industry.

Although De Beers has in the past exerted far-reaching control over the diamond industry, its lengthy monopolistic control of the diamond trade has in part led to its own demise as the sole dominant force within the global diamond trade. In an industry that it essentially helped forge, De Beers has become a victim of its own successes. By so tightly controlling supply for so many years, De Beers's market dominance gave rise to antitrust and regulatory threats from governments, defecting industry players looking to grab a larger slice of the value chain and waves of bad press due to De Beers's perceived complicity in the funding of atrocities and civil strife in diamond-rich Africa. Moreover, the discovery of substantial new diamond sources not directly controlled by De Beers led to an inevitable increase in market supply, thereby increasing the financial commitment of De Beers to maintain its role in the market as buyer of last resort.

It has become apparent that De Beers no longer can operate under the model that made it so immensely successful in the past. In fact, in an acknowledgment of this, De Beers has made a pronounced shift in its market strategy toward a more demand-driven focus, abdicating its prior role as a market regulator. However, as vertically integrated competitors move to do the same and as synthetic diamonds grow in popularity, De Beers faces stiff competition at the consumption end of the diamond value chain. Furthermore, the fundamental question remains whether De Beers's foray into diamond branding can prove successful. After decades of broadly promoting the entire diamond industry and diamond consumption, can De Beers successfully engineer an about-face and educate consumers to differentiate between diamond brands? It remains difficult to say at such an early juncture in the industry's most recent evolution. However, the fact remains that the days of business as usual for De Beers are long past.

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