

Center for Digital Technology and Management

De Beers Case

14.12.2007

Oliver Hoffmann, Julia Ju, Senta Plein, Pujan Ziaie





Agenda

1

The key factors for the diamond cartel longevity

2

The diamond industry structure, change and rechange possibilities

3

Learning from history for other lines of business



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The diamond industry structure, change and recharge possibilities

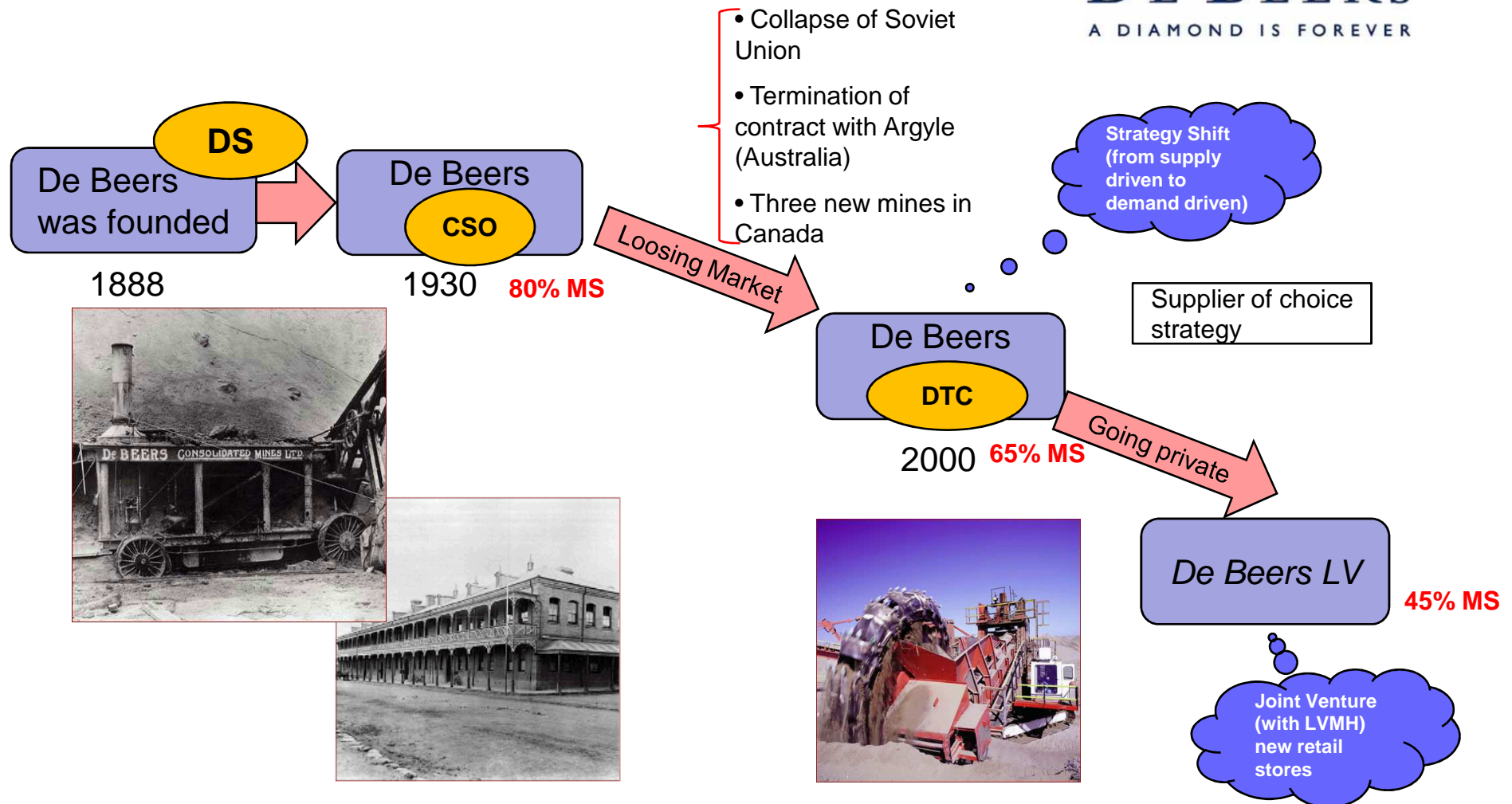
3

Learning from history for other lines of business



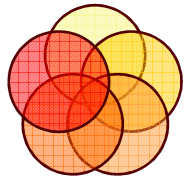
1. History of De Beers diamond cartel

DE BEERS
A DIAMOND IS FOREVER





1.1 The key factors for the diamond cartel longevity during the 20th century



Starting as a Monopoly in the 19th century

→ Finance strength; Access to high quality diamonds

**Effective ways to prosecute
members of the cartel severely**

**Longevity of De Beers Diamond
Cartel due to the 20th century**

Almost no substitutes

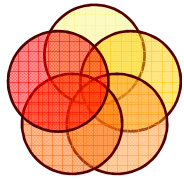
→ Industry: Highest hardness 10;
no Fullerites or ADNRs available
→ Jewels: „Diamonds are forever“

Cushion and controll of supply quantity

Special elasticity of luxury goods



1.2 Through the intermediary role, the cartel can punish producer and merchants



Effective ways to prosecute
members of the cartel severely

$$\pi_{\text{Cartel}} > \pi_{\text{Cheater}}$$

$$\alpha \pi_M > R_{\text{Cheater}} - \delta C$$

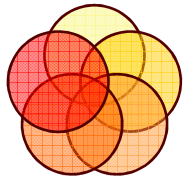
As the CSO controls ~85% of world trade,
deviation can easily be detected.

- exclude deviator from future trade
→ decline in popularity

- increase number of substitutes for
the products of the deviator
→ price drops



1.3 Through the intermediary role, the cartel can punish producer and merchants

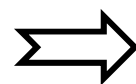


Effective ways to prosecute
members of the cartel severely

For merchants being part of the Sightholders is important, because de Beers is monopolist in top-quality diamonds.

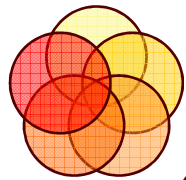
- Thread to exclude merchants who buy from competitors or deviators is effective.

→ complicates deviation

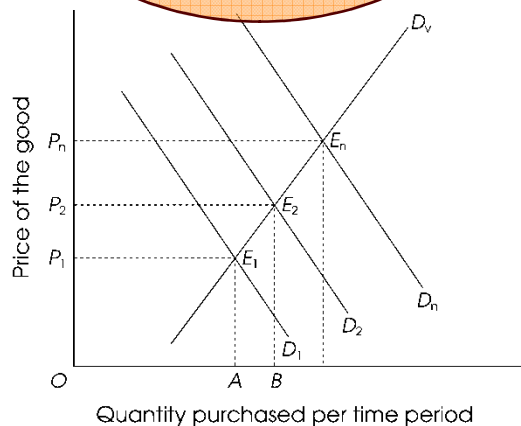


- Effective enforcement of cartel quantities possible.

1.4 Only with luxury goods, a cartel will be stabile



Special elasticity of luxury goods



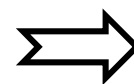
Duncan Reekie „Diamonds: The Competitive Cartel“

How price effects demand:

↓ Especially for industry diamonds a rising price level results in a drop in demand.

↑ The „Veblen effect“ for luxury goods:

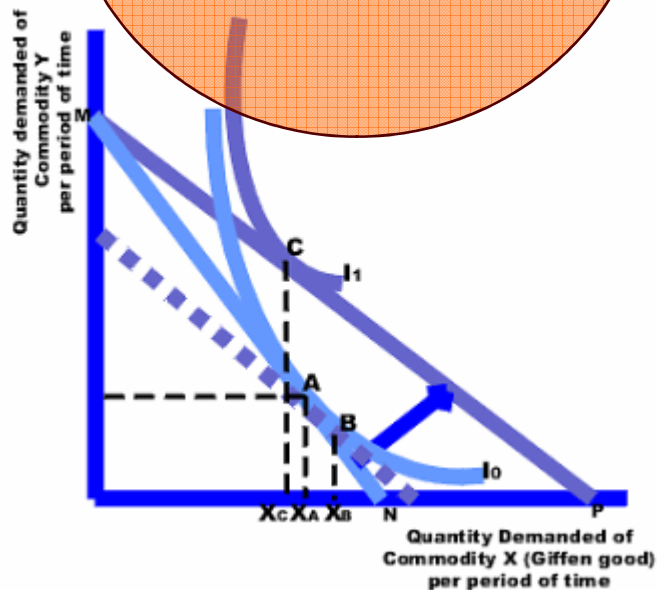
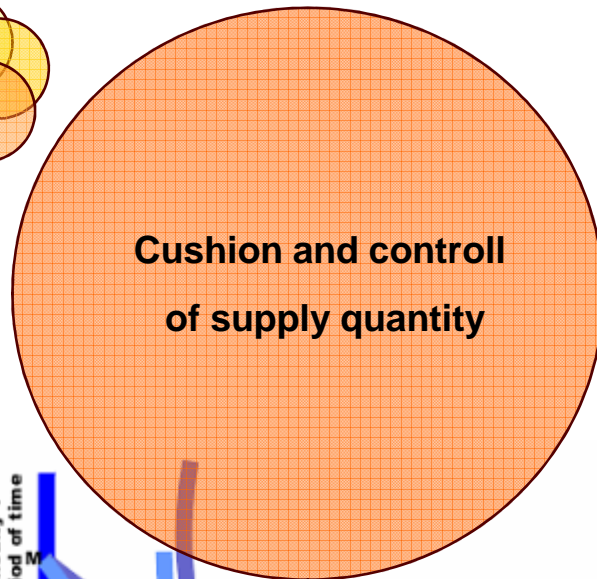
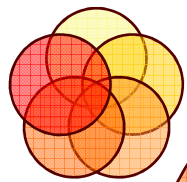
- Price changes the demand curve
- Higher price results in a rise in demand



Low (possibly negative) price elasticity in luxury goods



1.5 Stability of prices by cushion has enforced the diamond cartel



Because of the „Veblen effect“ the market collapses if price drops too low.

Therefore suppliers and customers are interested in a constant price on a high level.

⇒ Control of supply quantity is necessary.



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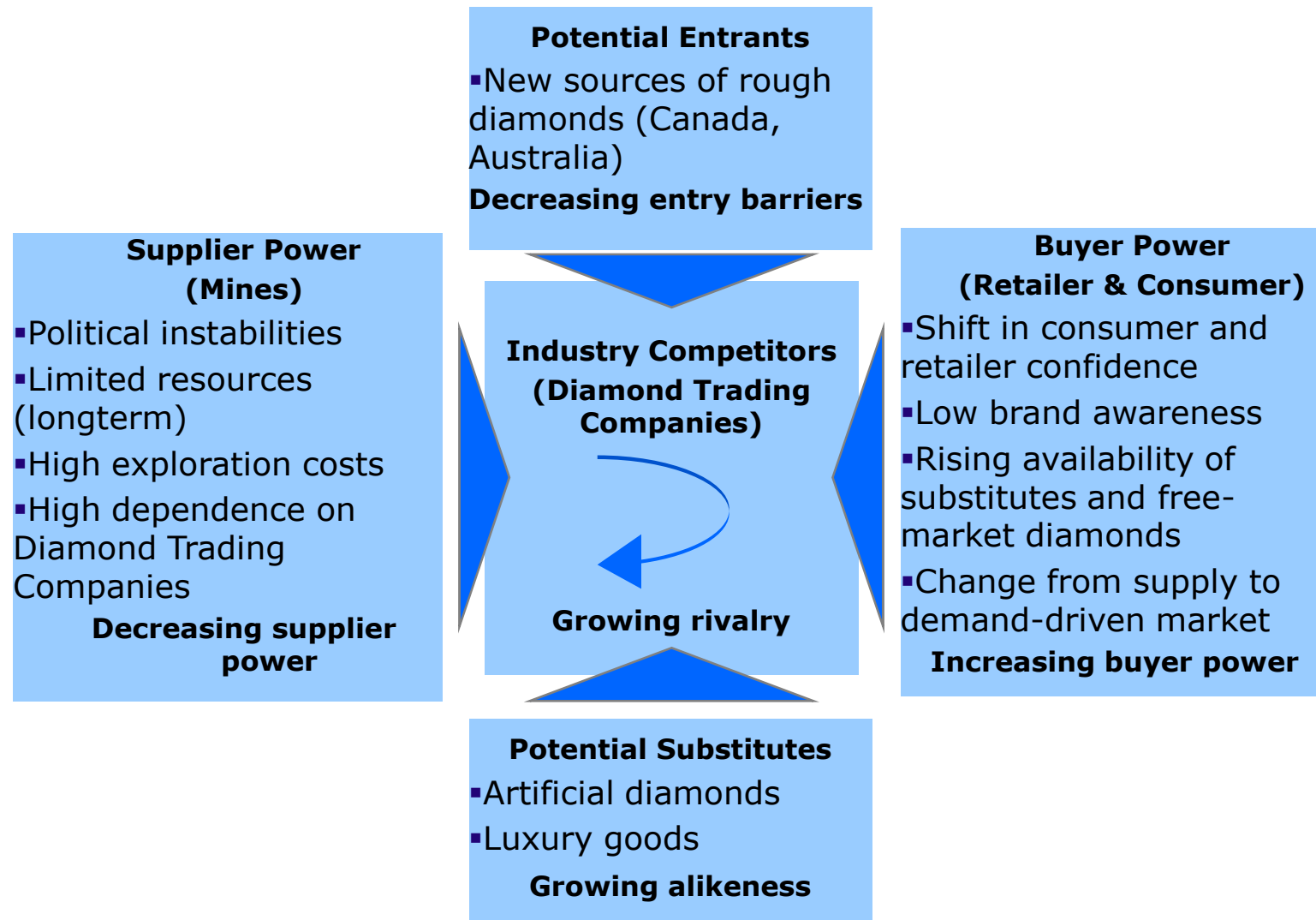
**The diamond industry structure, change and
rechange possibilities**

3

Learning from history for other lines of business



2 The diamond industry structure is changing





2.1 The Diamond Industry – Growing Competition

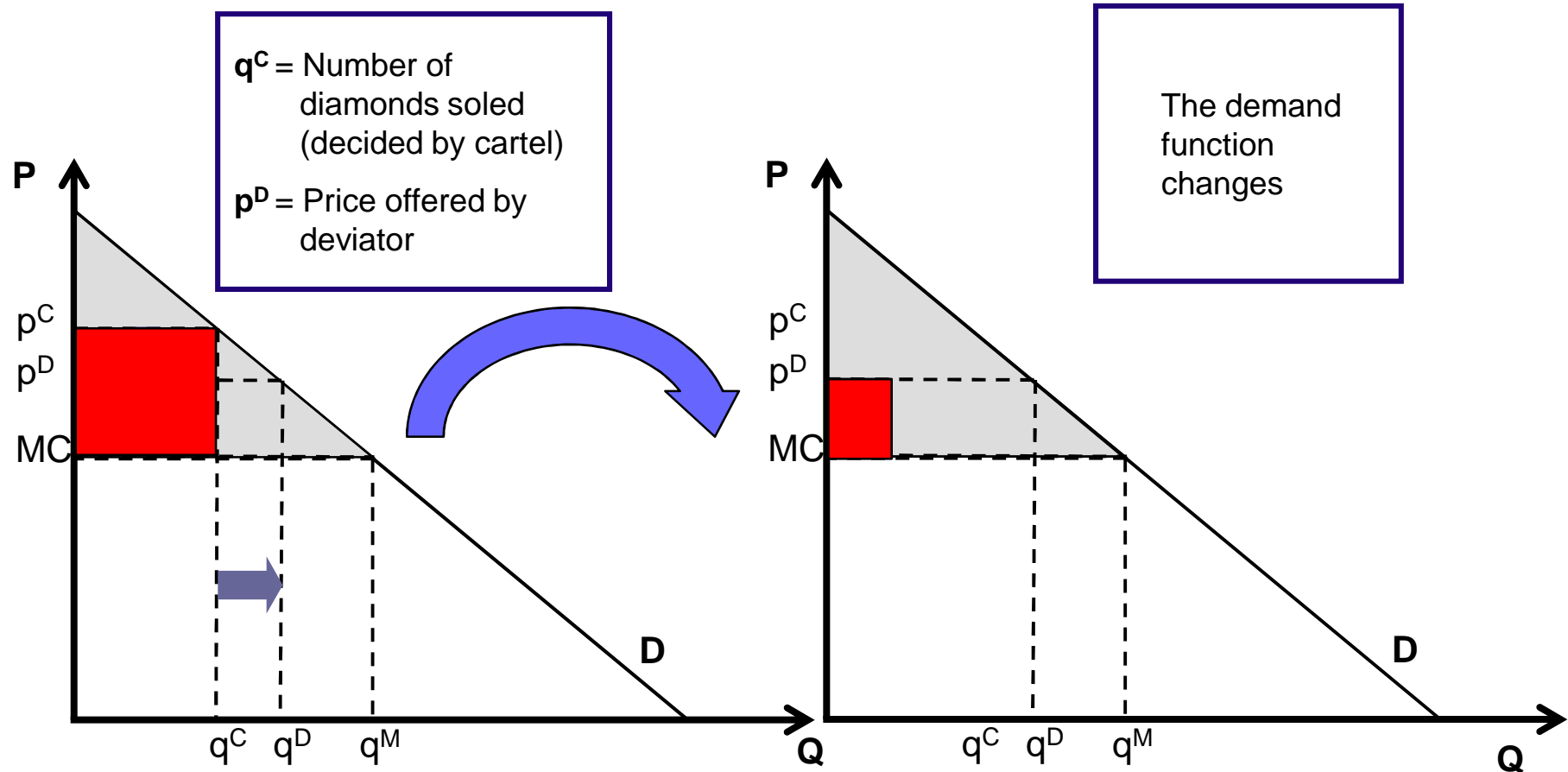
- **Consequences for De Beers:**
 - Market share fell from 85%(1990) to 45%(past years)/50% (2007)*
 - Reduced profits
 - Decreased shareholder confidence
 - Growing distribution outside De Beers' cartel → difficulties in price stability
 - Decreasing control and retaliate possibilities
 - Financial pressure of holding large buffer reserves (5,3 Bil. CHF)*
 - Growing switching probability for customers due to less brand identity
 - Freeriding problem

*Solitaire International Wordpress (2006)

*NZZ folio



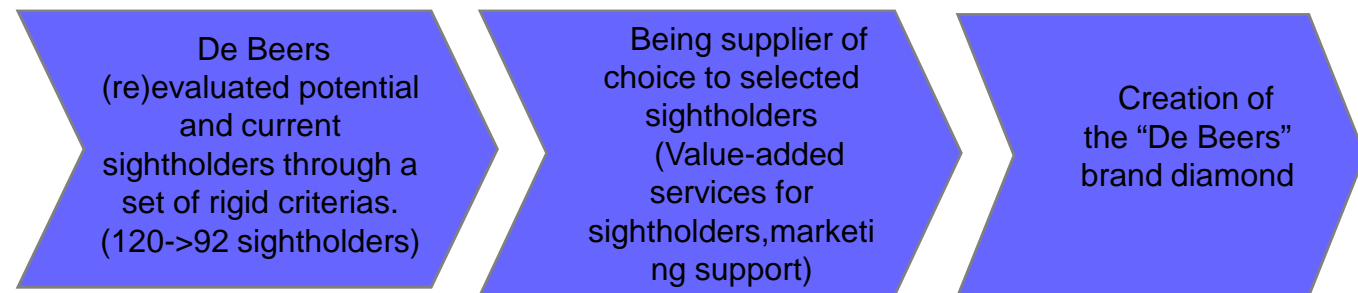
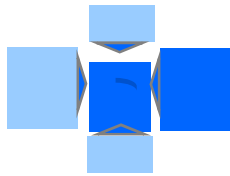
2.2 Economic Analysis of De Beers' Situation



→ How can De Beer react to recharge industry structure?



2.3 The Supplier of Choice Strategy (SoC)

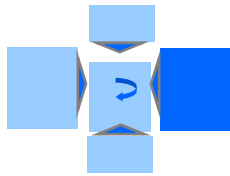


- Incentive to advertise in order to shift demand from competitors to De Beers
→ switch from generic to brand advertising
→ horizontal product differentiation
- Price competition ↓ (positive price-cost margins), market power ↑ higher degree of brand differentiation
- Minimize freerider effects
- Strengthen retailers and customers confidence in De Beers
- Encouraging consumer demand and total sales

→ De Beers strengthens its competitiveness over brand differentiation



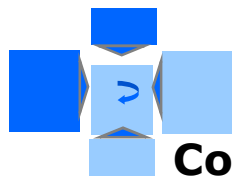
2.4 Possibilities to downsize buyer power



- **Driving demand**
 - Problem: Sales of diamonds were underperforming in contrast to other luxury goods
 - Solutions:
 - Various possibilities in Asia → Strong marketing initiatives India, Japan and China to conquer the new markets
 - Forever campaign
 - New ways of advertisement
 - aggressive and innovative advertising („The diamond wedding ring“) to stimulate retail growth
- **Strengthen consumer and retailers confidence**
 - Problem: Potential issues affecting the industry
 - Conflict diamonds
 - Synthetics
 - Treatments
 - Money-laundering
 - Solutions:
 - Forevermark to mark genuine natural diamonds
 - Strong focus on positive PR and need to give retailers possibility to communicate issues.
 - Trade education to win heart and minds of downstream trade
 - Disclosure to ensure all synthetics are fully disclosed
 - Detection to rapidly identify any genuine diamond

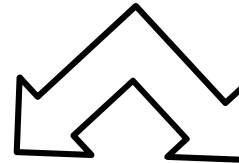


2.5 Two ways to react against new competitors



Continued Competition

- Reduce expectations in Canadian mills
- Buy mills wherever possible
- Set longterm contracts to buy diamonds from other mills



Renewed Collusion

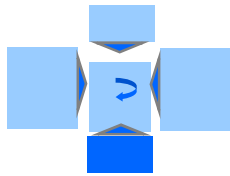
Syndicate creates value

- Transaction cost
- Market stability generates trust
- Market power

Win-Win possible, if syndicate-revenues can be shared equally and quantity enforcement is possible



2.6 Prospects to handle with potential substitutes



- **Artificial diamonds**
- Problem: High importance in the industrial market because of high purity and low costs → Probability of entry in jewellery market
- Solution: DeBeers has to deter entry of artificial diamonds in the jewellery market:
 - Costs of deterrence:
 - Competition ↑, Prices ↓, Profits ↓
 - Entry barriers has to go up:
 - Marketing
 - Customer/Retail Lock-in → switching costs
 - Investment in detection technologies
 - If market entry:
 - Brand differentiation
- **Luxury goods:**
- Problem: Great increase of luxury goods in past years, shift of consumers preferences (10-15% p.a.)
- Solution: Vertical integration:
 - De Beers joint venture with LVMH → DeBeers LV retail stores
 - Downstream branding development
 - Establishing sufficient brand awareness and profit from own name on all levels of diamond pipeline



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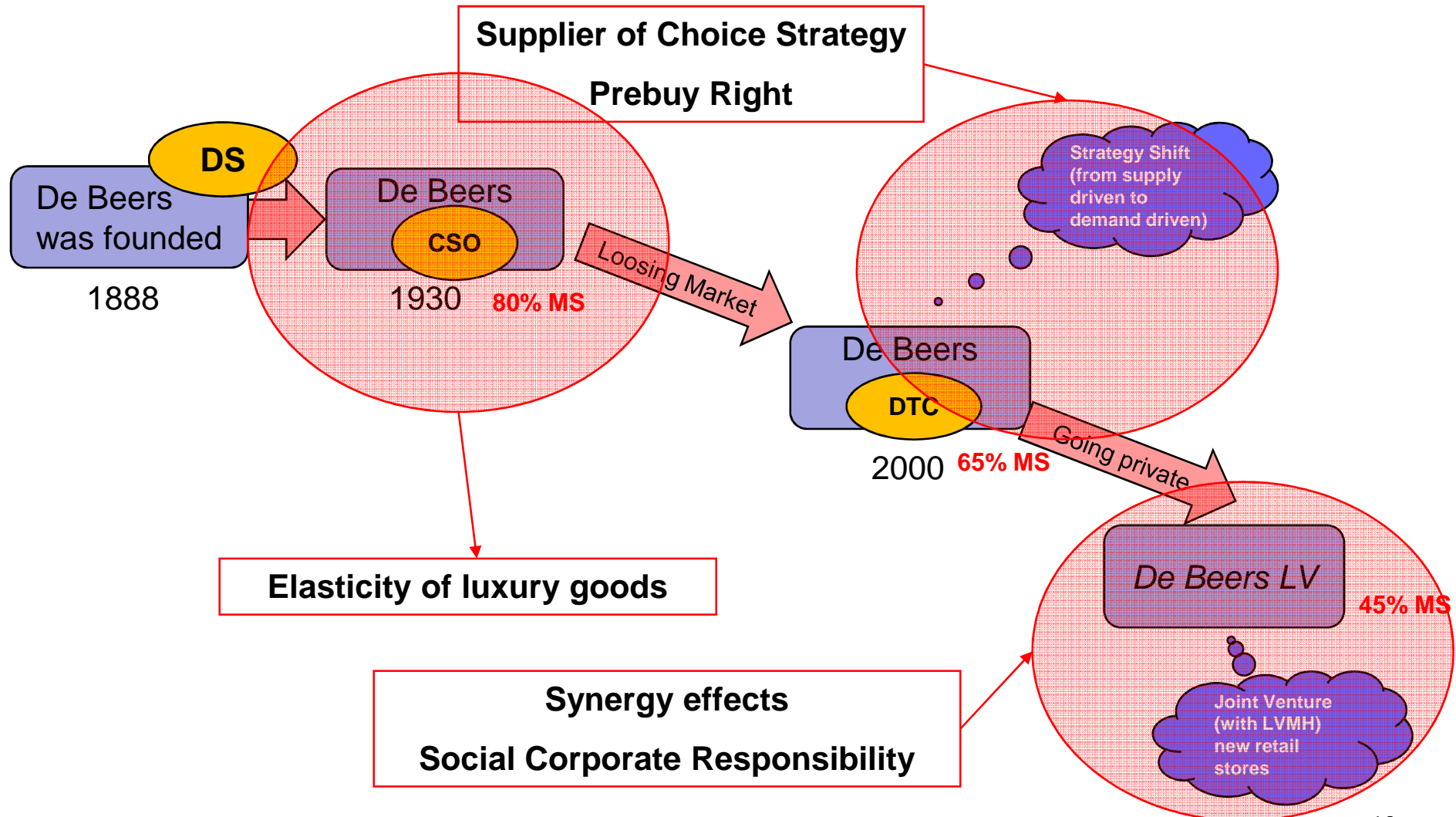
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3 Learning from history for other lines of business





3.1 You can learn for the luxury-good market:



Special **elasticity of luxury goods** can also be used without a cartel; prices are high

→ Alliances are possible

Booming market (2006):

- Growth of HNWI: ~6% p.a.
- Growth of UHNWI: ~9% p.a.

Prebuy-right for special merchants can copy and extend the successful **SOC-Strategy** of the cartel

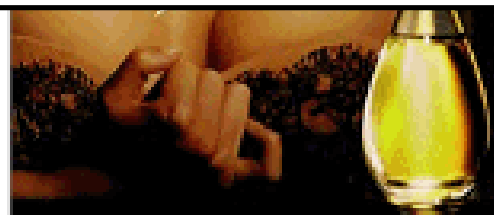
• Evolving markets in Asia, India and Russia

• Organic growth of LVMH: + 12%

• World market growth: ~ 7% p.a.

Like in the diamond business, customers are concerned about the **social corporate responsibility**

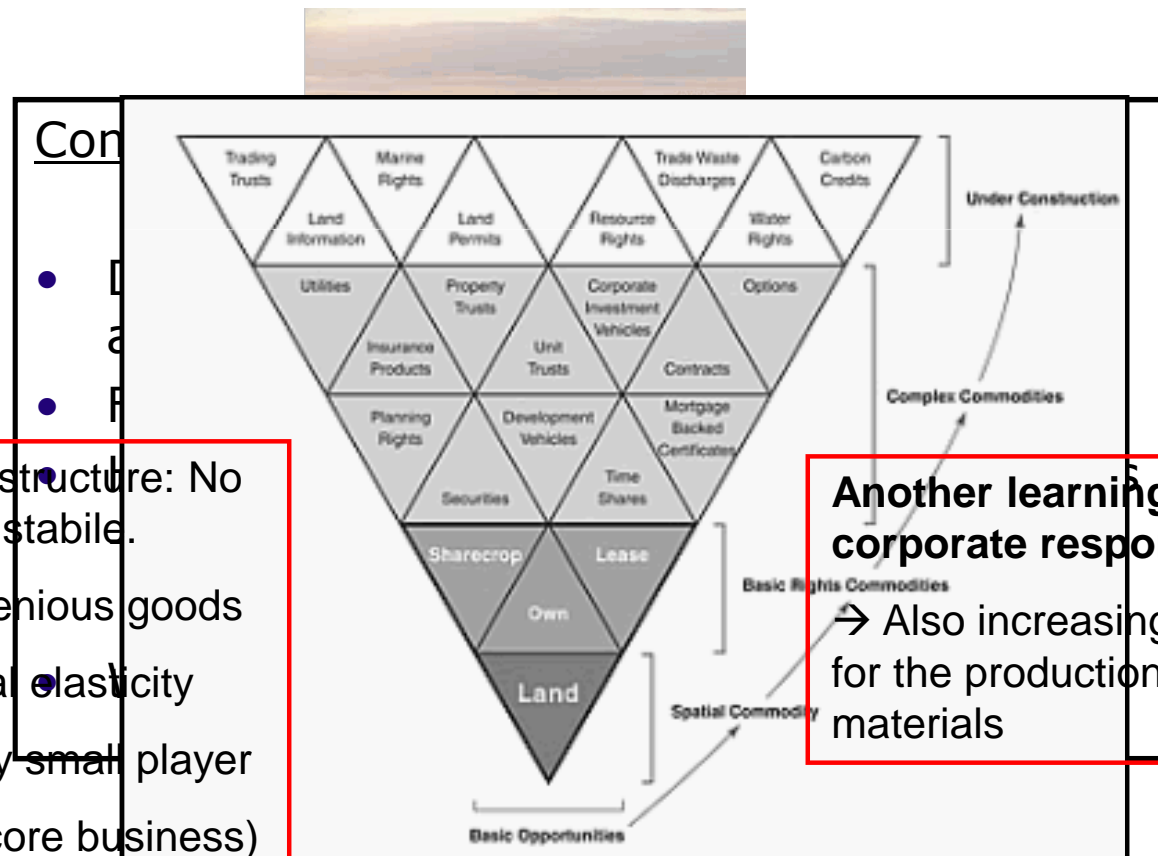
→ Increasing relevance for the production of luxury goods





3.2 You can learn for the raw materials/commodity market:

→ That you can not learn too much: De Beers plays a different role.



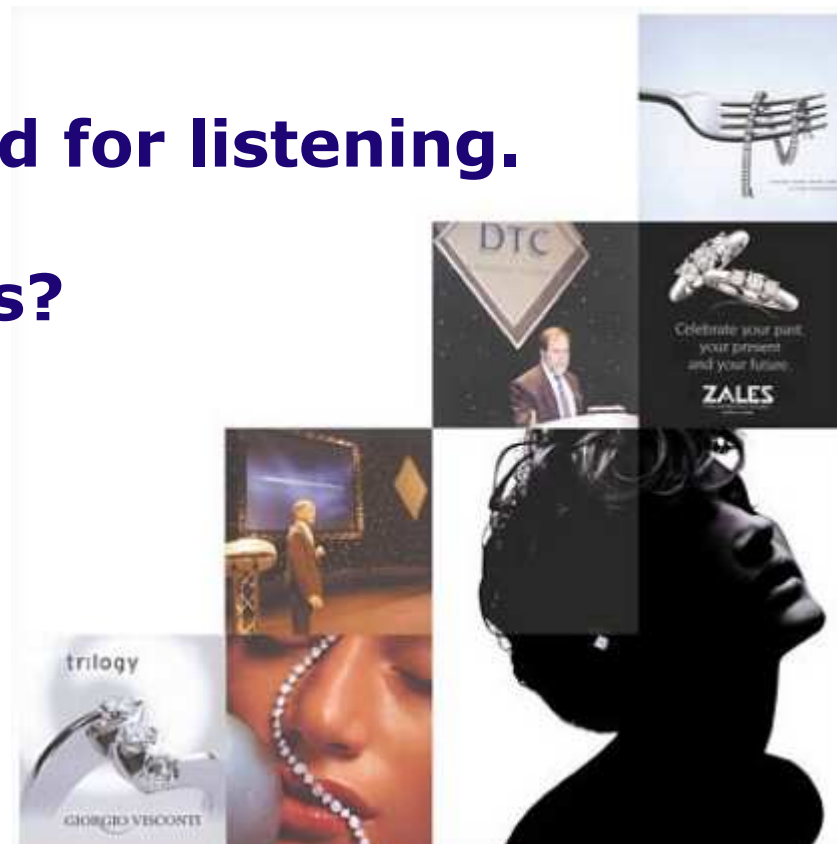
Special market structure: No cartel was ever stabile.
 → Quite homogenous goods
 → Almost normal elasticity
 → De Beers only small player
 (not core business)

Another learning: social corporate responsibility
 → Also increasing relevance for the production of raw materials



Thanks to the board for listening.

Any open questions?





Back up



Literature

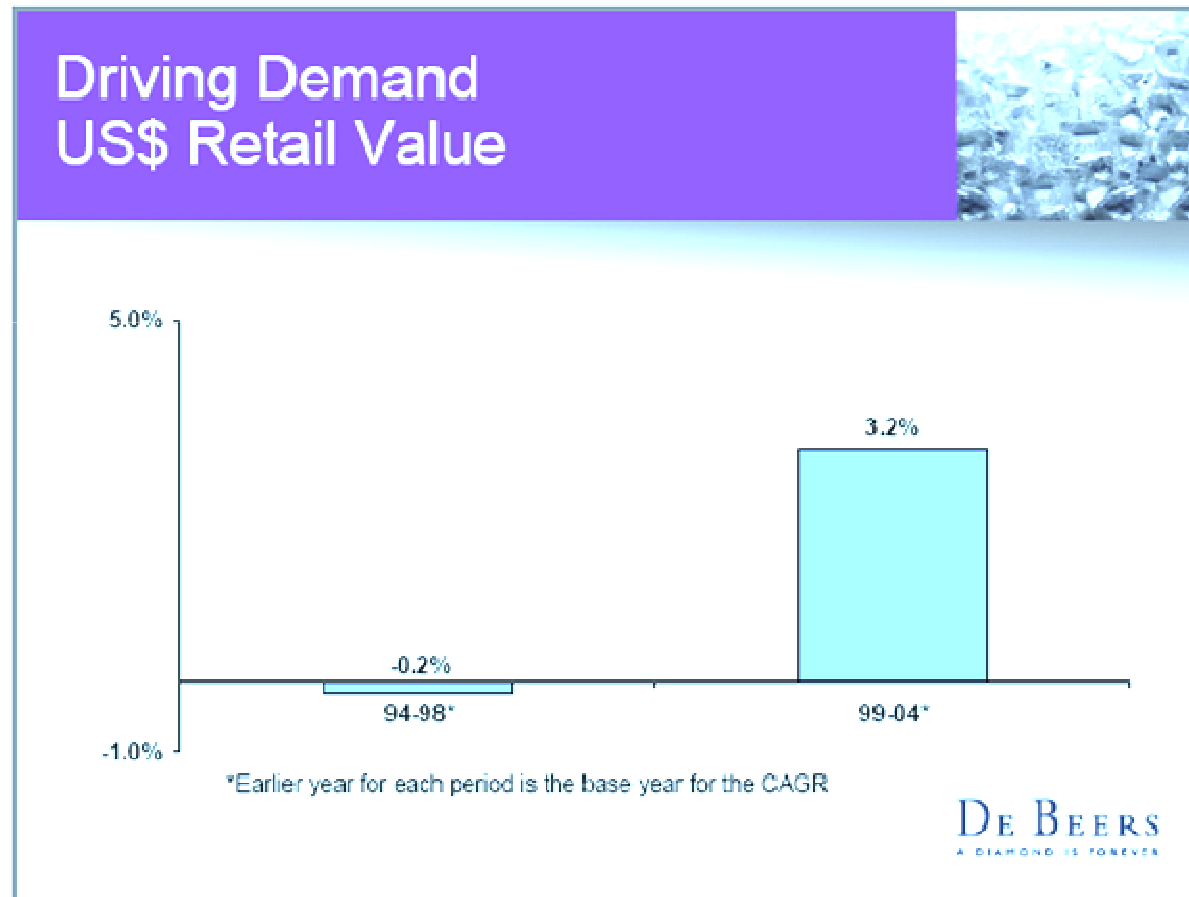
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De Beers success to drive demand



De Beers advertising campaign in China



The Diamond wedding ring: a cultural imperative in the big cities





- China: the diamond jewellery market of the future
- 11% growth in 2004 vs 2003, the first double digit increase
- 8 out of 10 brides in Shanghai receives a diamond for her wedding
- 51% Acquisition rate in urban China

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