De Beers Consolidated Mines Limited

De Beers: Stability of the Mining Industry, 1888 to 1999

&

De Beers' Strategic Review, 1999 to 2000

A Case Study Research Report

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By

Craig Kraus & Scott Thompson

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Supervisor: Professor Gary J. Stockport
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This report is strictly private and confidential to Professor Gary J. Stockport of the Graduate School of Business and may not be viewed by anyone else until further written notification to the contrary.

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We certify that except as noted above the report is our own work and all references are accurately reported in footnotes.

Signed:      Signed:
Craig Kraus        Scott Thompson
ABSTRACT

De Beers Consolidated Mines Limited

The De Beers case studies are particularly relevant in a strategy course since the evolving history of the company contains valuable lessons regarding the management of stakeholders, the identification of important market signals and strategic transformation.

The overall aim of the case studies is to document the history of De Beers with a focus on transformation in the context of De Beers’ old strategy. The primary aim of the first case study is to demonstrate how originally Cecil John Rhodes and then De Beers managed the relationships between the major producers in the diamond industry so as to benefit both De Beers itself as well as the industry as a whole. This case study concludes with a description of the landscape in the 1990’s and illustrates the types of market signals that emanated from key producers in the industry. The second case study commences almost exactly where the first one left off and concentrates on the strategic transformation of De Beers. The aim of the second case study is to illustrate how strategic change is being implemented by De Beers and how De Beers has decided that it will transform itself from keeper of the diamond cartel to the largest company in a more competitive diamond market.

Given the importance of the mining industry for South Africa and the fact that De Beers, a South African company, is the world’s largest producer of diamonds in the world it is submitted that all students and executives who are trained in South Africa and other diamond producing countries would benefit from gaining an understanding of the history of the company and how it operates.

KEYWORDS: Diamond Industry, Game Theory, Strategic Transformation, Single Channel Distribution, Trends, Market Signals.
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DE BEERS: STABILITY IN THE DIAMOND INDUSTRY, 1888 TO 1999

"In Africa think big"
Cecil John Rhodes
THE DISCOVERY OF DIAMONDS IN SOUTH AFRICA

It is recorded that diamonds were first discovered in Indian riverbeds 7 or 8 centuries before Christ. Diamonds were also discovered in the jungles of Brazil in the 18th century, and the peak of Brazilian production occurred in the middle of the 19th century. The Brazilian deposits, like the Indian diamonds, were alluvial (found in the beds) and it was only discovered later that alluvial diamonds result from the erosion of kimberlite pipes¹.¹

Before the discovery of diamonds in South Africa, diamonds were regarded as being far beyond the grasp of the majority of citizens, and only affordable to royalty and the elite classes of society. Nevertheless, with the discovery of large deposits of diamonds in South Africa in the 19th century came the potential for diamonds to be commodities, and mass market items. The first diamond discovered in South Africa was found in 1867, on the banks of the Orange River, in the Northern Cape, by a fifteen year old Boer boy near Hopetown but the media did not take much notice. In the following year more diamonds were discovered on the banks of the Vaal River, in the Northern Cape and this time a London diamond merchant sent out a mineralogist to inspect the discovery. He dismissed the possibility of there being any significant diamond deposits in South Africa. The first South African diamond rush was sparked off when a Griqua² sold a “special pebble” to a farmer for 500 sheep, 10 oxen and a horse. The farmer sold the same stone to a jeweller for £11,200. The Earl of Dudley eventually purchased the stone for £30,000 and it was to become famous as the 'Star of Africa.' Newspapers covered this purchase and this time the news suggested that there was a plentiful supply of diamonds in South Africa. Floods of diggers stormed to Hopetown, on the banks of the Orange River in the Northern Cape.

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¹ The kimberlite pipes are formations of crushed rocks that volcanic activities thrust to the surface from depths of more than 150 kilometres. Diamonds, a form of crystalline carbon, are forged deep in the earth by immense heat and pressure, trapped in lava and having been pushed up by explosive force, are contained within the kimberlite pipes.

² Griqua is the name given to indigenous group of people from a region of the Northern Cape in South Africa.
These diggers fanned out from Hopetown and in 1871 diamonds were discovered at night by a group of diggers on the Colesburg Kopje\(^3\) near Kimberley, about 200 kilometres away. Hundreds of adventurers stormed the Kopje and within weeks 800 claims had been staked. The town that sprang up overnight was initially called New Rush and in 1873 it was renamed Kimberley. Shortly afterwards, the Kimberley Mine (now known as the Big Hole) was discovered a mile away.\(^ii\)

**THE ARRIVALS OF CECIL JOHN RHODES AND BARNEY BARNATO**

In July 1873, Barney Barnato set sail from England to Cape Town to join his brother at the diggings. After he arrived in Cape Town, he walked from Cape Town to Kimberley, a journey that took him almost 2 months. He started off as a pugilist (boxer), then peddler and comedian. He also bought and sold diamonds but at the time the problem was finding diggers who sold at cheap prices. To address the problem, he ingeniously bought an old, fragile horse from a merchant who had previously had dealings with many diggers who were unaware of current market prices. Obviously, the merchant had jealously guarded the names of the diggers because he did not want anyone else interfering. As Barnato expected, the horse that had become so accustomed to doing the usual rounds took him directly to the diggers he was searching for.

In 1874, Cecil John Rhodes also came out to the diggings in Kimberley from the United Kingdom. Early accounts of Rhodes describe him as a man of serious demeanor and weighted with big thinking. He was a man who would grow old prematurely, who callously ordered men around on the fields.\(^iii\) Rhodes initially made a living at the diggings by renting out a steam-powered pump that replaced the hand-held pumps that had been used by the diggers to pump water seepage out of their claims. With the money he earned from this business, he started buying small claims in the De Beers mine. At that stage the environment was in turmoil. In 1876, there were 3,600 claims in the hands of 98 syndicates and it was clear that a reorganization was required. Early on in his career at

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\(^3\) A Kopje is the name given to a hill in South Africa
the diggings, Rhodes noticed that many diggers who came into town on Fridays to sell their diamonds did so at throw away prices. He hypothesised that the average miner was perturbed by the gradual fall in the price of diamonds but ignorant of the cause, and still went on over producing. If all the diamonds found in the South African mines were exported to Europe, the market would be quickly flooded and prices would plummet. Were this to happen, diamonds would also lose their allure of being scarce items in the mind of the consumer. By the late 1870’s, the diamond prices had deteriorated to such an extent that one third of the diamond companies had been forced to close down. Rhodes started contemplating ways to save the situation and his first objective was to bring all diamond claims under one control to regulate the diamond industry by equating diamond output with world demand. As Godehard Lenzen, an early commentator on the diamond industry put it:

“As early as 1873 the recorded pronouncements by Rhodes clearly indicate that his main aim is nothing less than the adaptation of the supply of rough diamonds to the market-dependent world by means of centralizing the control of production…. As an inevitable result of future technological developments in diamond mining he saw the continually rising production reaching a market whose trend of demand, although likewise on the increase, appeared frequently to be rendered unstable by local as well as world-wide recessions. The quantity of rough diamonds produced was to be continually adjusted to the intensity of demand”.

THE STRUGGLE FOR CONTROL

Rhodes began to fight for control of the diamond industry. This involved firstly consolidating the claims in the De Beers mine. In 1873 he linked his claims in the mine with those of Charles Rudd and they bought up as many other claims as they could. The union led to the formation of the De Beers Mining Company in 1880 with a capital of 200 000 pounds. Having consolidated control of the De Beers mine he set out to gain control of the Kimberley Mine. The most successful claims in the Kimberley Mine were owned by Barnato’s Central company. However, there were claims that were strategically
well positioned in the mine. They were owned by a French company. A frenzied competition for these claims and control of the mine ensued between Barnato and Rhodes resulting in a bidding war between the two. Rhodes then approached Barnato with a proposal. Rhodes would buy the claims owned by the French company and would then resell those claims to Barnato for a certain purchase price, including a 20% stake in Barnato’s Central company. Even though this would reduce his stake to less than 50% Barnato accepted the offer assuming that his alliances with other minority shareholders would keep him in control of the company. But Rhodes showed that money creates its own loyalties. By offering premium prices to minority shareholders for their shares he had managed to obtain majority control, and Barnato was eventually forced to capitulate to the man of vision. Rhodes bought out the remaining claims in the Central company for 5,338,650 pounds (worth approximately 300 million pounds today). Barnato’s concluding words at four in the morning were: “Some people have a fancy for this thing and some for that; you have a fancy for making an empire. Well, I suppose I must give it to you.” Rhodes admitted that Barnato “fought me tooth and nail” but Rhodes had won and now the two great diamond mines Kimberley and De Beers were controlled by Rhodes and output could be regulated according to demand.

In the 1889 Board Meeting of De Beers Consolidated Mines Barnato said that the amalgamation had justified itself. De Beers Consolidated Mines was producing a smaller caratage (supply) of diamonds than before but was receiving the same amount of money for them. Previously, when producers had been competing, they only received 20 shillings per carat but now they received 30\(^iv\)

In 1890, De Beers signed a sales contract with the newly formed London Diamond Syndicate which consisted of 10 different companies, each of whom purchased a share of the De Beers production. This arrangement can be regarded as the birth of the De Beers Central Selling Organisation (CSO), which will be referred to later.\(^4v\)

\(^4\) The term Central Selling Organisation (CSO) is a collective reference to the companies used to manage the supply of rough diamonds onto the world markets. The company responsible for sales within the Central Selling Organisation is the Diamond Trading Company.
These were the seeds and origin of De Beers’ belief and policy that diamonds should not be forced onto an unwilling market and this is in the interests of all stakeholders in the entire diamond industry. De Beers’ belief is that producing more diamonds and putting them on the market will not result in any more money being obtained in the whole from the consumers. The effective application of this philosophy is, however, only truly put to the test when there is a slump in the demand for diamonds, or is threatened by new discoveries. The law of supply and demand still applies

In 1890, De Beers initially satisfied approximately 90 percent of the world’s demand for diamonds. Table 1 shows De Beers production for its first 10 years from 1889 to 1897. vi

Nevertheless, De Beers had sought to acquire ownership of any mines that were "too poor to work, too rich to ignore," resulting in the leasing and acquisition of several other mines in and around Kimberly. There were some small mines and alluvial diggings that sold their production directly onto the open market but these were not large enough to cause any real concern for De Beers.

Cecil John Rhodes died of heart failure in 1902.

NEW DISCOVERIES ACROSS SOUTHERN AFRICA AND THE CONTROL OF PRODUCTION

In 1898, Thomas Cullinan discovered diamonds on a farm near Pretoria. The farmer was a deeply religious man and was not interested in negotiating the disposal of the farm. When he died however, his son and daughter agreed to sell the farm to Cullinan for £52 000. Capital was raised by issuing shares in a newly formed company, called Premier Transvaal Diamond Company. The then Chairman of De Beers, Francis Oats, thought that the whole thing was a hoax. Gradually, however, Cullinan’s diggers came up with more and more diamonds. Oats, however, he still did not regard the mine as a serious
threat because he felt that the grade of the diamonds were inferior. Nevertheless the new De Beers Directors, Alfred Beit, differed. On a visit to Premier Mine he realized that the mine constituted a significant threat to De Beers and within 3 years, the mine had produced 1,890,000 carats of diamonds. This output competed with that of De Beers and, on top of that, Premier had established its own selling operation in London. Negotiations ensued and an agreement was reached whereby Premier agreed to sell its production to the London Diamond Syndicate. Premier, however, broke away from the Syndicate in 1906.

In 1908, diamonds were also discovered in the then South West Africa, a German colony at the time. The Germans sold their production through an organization known as the Diamond Regie, which received a commission of 5% on all diamonds sold. This continued until the Germans also realized that it would be best for all producers to sell their output through one channel. Diamonds were being offered to all and sundry on the marketplace and buyers had been selling in competition with one another. Instead of having several weak sales units it was decided that there should be one company through which all diamonds should be sold. A conference was accordingly called where representatives of De Beers, Premier and the Diamond Regie were present. At that conference in 1915, it was agreed that all diamonds would be sold through the Diamond Syndicate whereby, a maximum value would be delivered to the Syndicate and each producer would sell to the Syndicate in accordance with certain quotas. This agreement lasted for 5 years.

In 1926, Dr. Harold Harger discovered the diamond fields at Lichtenburg, in the then Western Transvaal. It sparked off a new rush of diggers and resulted in significantly increased output. Also in 1926, came the discovery of diamonds in the oyster-beds and terraces at Alexander Bay, just south of the mouth of the Orange River. These discoveries were a source of anxiety for De Beers particularly since there was a large output of alluvial diamonds from Lichtenburg. Before the Lichtenburg discoveries, the South African alluvial output had averaged at £1,854,550 per year, but subsequently it had gone up to £6,528,000 pounds. This was materially impacting on the major producers.
SIR ERNEST OPPENHEIMER

“I have had a very lengthy connection with the diamond trade and my experience has taught me that only by limiting the quantity of diamonds put on the market, in accordance with the demand, and by selling through one channel, can the stability of the diamond trade be maintained. The danger to the security of the diamond industry is not the discovery of a new rich diamond field but the irrational exploitation of it”.

Sir Ernest Oppenheimer

Sir Ernest Oppenheimer initially came out to South Africa from London as a representative of the Dunkelsbuhler family, one of the members of the London diamond buying syndicate referred to earlier. Although he soon became known as a very talented diamond dealer, his first major business moves involved gold, not diamonds, and helping German investors acquire gold mines before the first world war. During the war, he formed the Anglo American Corporation and he used that company as a vehicle to purchase a diamond mine that had been discovered in the then South West Africa in 1908. De Beers identified the threat and agreed to buy the mine from Sir Ernest Oppenheimer for a significant amount of stock in the company, and also gave Sir Ernest Oppenheimer a seat on the De Beers Board.

In 1929, Sir Ernest Oppenheimer was elected Chairman of De Beers, just as the great world depression was looming. In his first appearance as Chairman of De Beers Sir Ernest reviewed the diamond crisis and effect of the Lichtenburg and Namaqualand\(^5\) discoveries. He said that the situation had been saved by the action of the London Syndicate in buying excess production, knowing that its disposal would have to be spread out over several years. The Syndicate spent millions of £s buying diamonds in order to

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\(^5\) Namaqualand is an area in the West of the Northern Cape, South Africa
protect the market and in his speech, Sir Ernest referred to the tremendous burden that was put upon the Syndicate to maintain stability in the market. The major producers had passively assisted by holding back on production, which saw a decrease in sales and disappearance of dividends. The Syndicate had been left with a large stock of diamonds that would be disposed of when market conditions improved. Sir Ernest felt that it was important for the major producers to have a more direct voice in the disposal of those diamonds, particularly since the Namaqualand diamonds were of a type that brought them into direct competition with De Beers production. It was also important that the major producers did not have to rely solely on selling its most valuable diamonds. The lifeline of the industry consisted not only of the best gems but also of the mediocre stones. The major producers wanted to ensure that the bulk of its production would be acquired.\textsuperscript{xi}

\textbf{The Diamond Corporation}

As a result of discussions that took place between the 1915 Conference Producers and the Syndicate, The Diamond Corporation was formed in 1930. The Diamond Corporation took over the diamond stock and agreed to spread the sale of the stock over a period of years in order to ensure a share of the available trade to the Conference producers. The sales agreements between the producers and the Syndicate were transferred to the Diamond Corporation.\textsuperscript{xii} The relationship between De Beers and the Diamond Corporation was a close one, with Sir Ernest having been appointed as Chairman of the Diamond Corporation soon after its formation. Using this vehicle, Sir Ernest concluded agreements with all the major producers of the day, including the Belgians and Portuguese who were producing in Zaire and Angola. The Diamond Corporation gradually evolved into the Central Selling Organisation. Figure 1 indicates the % change in diamond sales from 1912 to 1945. The exhibit above gives an indication of the extent of market volatility before the formation of the CSO in the 1930’s and the gradual smoothing out thereafter.
The Great Depression

The diamond market suffered as a result of the depression and the prices of cut and polished\(^6\) diamonds fell by about 50% between 1929 and 1933. However, at the 1930 shareholder’s address, Sir Ernest stated that the control exerted by the Company and the Diamond Corporation would see De Beers through. He convinced investors that the production from the alluvial fields was a passing phase and that prices would be maintained.

As the depression worsened, the Diamond Corporation went as far as ceasing sales altogether. De Beers’ mines stopped production entirely in 1933 and 1934. During this time the Diamond Corporation also honoured the sales contracts that had been concluded with diamond producers in the Belgian Congo, Angola and West Africa for the purchase of their production, when it was virtually impossible to resell the diamonds. Its diamond inventory swelled to 20 million carats as a result.\(^{13}\)

At the 1932 General Meeting of shareholders Sir Basil Blackett (a De Beers director) observed that De Beers could not hope to prosper in a depressed world and that demand for commodities would only recover once consumer purchasing power increased. He alluded to De Beers’ underlying strength and said that the company would reap the reward of their patience and labour in due course. The depression did pass and in December 1934, the Board issued a statement to the effect that there had been a distinct improvement in the diamond trade and that diamond production could again commence.

The Golden Rules

In his address to the Annual Meeting in 1934, Sir Ernest devoted a lot of attention to the machinery of diamond selling. He reviewed the position of diamond control from production to marketing giving details of the acquisition of producers and the distribution channel of diamonds. He showed how the policy of Rhodes was being perpetuated and

\(^6\) Before diamonds pass into the hands of consumers they are cut and polished at various centres around the world.
that policy rested on two golden rules. Firstly, sales were limited through a single channel and, secondly, the company would attempt to gain control over production. With regard to the first, he stated that the producers had formed themselves into an association for the purposes of apportioning the available trade, and agreed to sell no diamonds other than through the association. In effect, this was a consolidation of the previous arrangements between the Conference producers but the scope had been enlarged, including not only the Conference producers but also several other producing companies. All the producers that were members of the association agreed to sell their diamonds through the Diamond Trading Company, a subsidiary of the Diamond Corporation, and the objective of the new company was to retain stability of prices. These arrangements had as their aim the maintenance of the principles in regard to the marketing of diamonds. Sir Ernest believed that, in order to maintain stability, the mining companies should co-operate not only in production but also in marketing methods and policies. That is why he later arranged for the South African producers, and later the Belgian, Portuguese and West African producers to acquire shares and become involved in the direction of the companies constituting the Central Selling Organisation.

Sir Ernest also referred back to De Beers' philosophy of attempting to control production. Apart from the acquisitions made just after the amalgamation, De Beers also acquired a controlling stake in the Premier Mine, Jagersfontein Mine, Consolidated Diamond Mines (also known as CDM, the then existing owner of diamond mines in South West Africa) and Cape Coast Companies (the owner of diamond bearing properties along the Cape coast). These acquisitions had all been made in an attempt to gain control of all the diamond properties in South Africa.

**HARRY OPPENHEIMER**

“...there is no one concerned with diamonds, whether as producer, dealer, cutter, jeweler or customer who does not benefit from it. It benefits not only the shareholders of
diamond companies, but also the miners they employ and the communities that are dependent on their operations. We are very conscious of our responsibilities not only to our shareholders, to the industry as a whole, but also to the governments of the countries in which we operate.”

Harry Oppenheimer

Just as Sir Ernest had taken the helm of De Beers in stormy times, so too did Harry Oppenheimer. After the demise of Sir Ernest in 1957, Harry was crowned as the new king of De Beers. At that stage, the CSO was handling more than 80% of the total world production of diamonds.xiv

Soon after he took over, Harry had to deal with the Williamson Mine in Tanganyika7 At the time, Tanganyika was about to achieve its independence from Britain. Harry initiated negotiations with the local leaders before they took over. A settlement was reached and it was agreed that De Beers would own a 50% stake in the mine and would provide whatever loans were needed for expansion. It was also agreed that the production emanating from the Williamson mine would continue to be marketed through the CSO.

But almost immediately after the deal had been struck, news came that diamond fields had been discovered in Siberia. By 1958, engineers had established that the discovery was a significant one, a whole field of diamonds 17 acres long and a half-mile wide. Once the public learnt of the discovery De Beers’ share price dropped from 114 British shillings to 82 shillings. This gave the Russians the upper hand in the ensuing negotiations as, if the Russians wanted to they could flood the market and potentially destroy the entire diamond industry. Harry met with the Russian producers and pointed out that it would be to the detriment of the entire industry if supply was not controlled, and that a single channel of distribution was in the interests of all diamond producers. In 1960, the Russians agreed to sell all their uncut gemstones to De Beers provided that the

7 Tanganyika was remained Tanzania after independence
route from mine to retailer was heavily camouflaged. The Russians insisted on this because they did not want to be seen as doing business with capitalists or South Africans, despite the fact that Harry Oppenheimer had helped found the Progressive Party to oppose the National Party’s apartheid\(^8\) policy.\(^xv\)

Control of Production - Managing Problems

These discoveries were symbolic of a trend away from the early days when the company produced 90% of the world’s diamonds and could limit the supply of diamonds to the market merely by holding back on their own production. From the middle part of the 20th century, this became more difficult and it became more important for De Beers to be able to persuade other producers that they should co-operate with the company in attempting to maintain stability in the diamond market. This required, first and foremost, that those producers sell a portion of their production to the CSO. In return, De Beers offered confidence that diamond prices would be maintained, publicity for diamond jewellery and, in certain instances, guarantees to purchase production even in market downturns. The producers realized that, the more of them that were part of these arrangements, the less likely that prices would become unstable. The strength of these arrangements, in turn, brought stability to the rest of the industry and benefited the diamond dealers and retailers.

THE DIAMOND PIPELINE

“The aim of De Beers, as leader of the diamond industry, is to maintain the long-term stability and prosperity of the industry as a whole. To that end, De Beers and its associates in the diamond business established and built up the Central Selling Organisation (CSO) which normally markets around 80 per cent of the world’s diamond

\(^8\) Apartheid – A philosophy advocating racial segregation
production, meeting as far as possible the different needs of the various cutting centers for the rough diamonds that are produced. Although the trend of retail demand continues to rise, setbacks in the trade in rough and polished diamonds do occur from time to time, usually affecting sales of particular sizes or qualities of diamonds, and stocks in the cutting centers can fluctuate sharply. The CSO’s policy during these periods is to maintain price stability by adjusting supplies to its clients in the cutting centers to prevailing demand, while maintaining its purchases from producers as a reasonable level in terms of quota arrangements. Undue curtailment of production is thereby avoided and the CSO, drawing on the De Beers group’s large financial resources, is able to hold the temporary surplus of diamonds in inventory until demand improves. The objective is to sell all new production over the cycle in the diamond trade. Stability has always been recognized as essential to the diamond industry, firstly because the price fluctuations that are accepted as normal in the case of most raw materials would destroy public confidence in the value of gem diamonds, which in terms of consumer spending are a luxury; and, secondly, because the new production of diamonds each year is a comparatively small proportion of diamonds in jewellery held worldwide.”

De Beers Annual Report 1994

In addition to their own production and the production emanating from CSO contracts with other producers, De Beers also bought up rough diamonds on the open market.
through buying offices in Africa, South America and Europe. Once De Beers has obtained its diamonds, whether they come from De Beers’ own mines or whether they had been purchased from other producers, they are sent to the London office of the CSO. The staff at the CSO sort the diamonds into more than 14,000 categories based on combinations of shape, quality, colour and size (see figure 2).

Selected diamond cutters and polishers or dealers, known as sightholders, are invited to attend the “sights” that are held 10 times every year in London, Luzern or Johannesburg, when diamonds are sold by De Beers to the sightholders.

Prior to the sights, the sightholders will indicate to the CSO what their preferences are in terms of how many stones they want, what their sizes and colours should be etc. The CSO will try to accommodate those requests as far as possible, but will also take into account several other factors, including the level of diamond stocks held by the CSO, the prevailing prices for polished diamonds and consumer trends. De Beers monitors the market by retaining close contact with sightholders, dealers in polished diamonds, manufacturing jewellers, leading retail chains and selected individual jewellers. The diamonds that are allocated to the respective sightholders are then put into parcels and offered and generally sold to the sightholders at the sights (see figure 3 for diamond pipeline).

In this way, the CSO is able to have a major influence on the diamonds that enter the market. It can regulate the number and types of stones, as well as influencing the price of those diamonds. The policy is geared at supporting price stability by regulating supply in accordance with prevailing demand. In this regard, it must be remembered that diamonds are not homogenous and do not have a standardised unit price. Each diamond is classified and valued individually. If prices for diamonds were allowed to fluctuate, consumer confidence in the value of diamonds would be undermined. That is why De Beers purchases diamonds from other producers and on the open market. If there is a temporary

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9 As part of the Strategic Review, (covered in de Beers’ Strategic Transformation), however, De Beers announced its intention to move away from being the *buyer of last resort* to the *supplier of choice*. 22
surplus of diamonds, they hold back from selling until demand improves. The success of the policy rests on a number of factors. Firstly, contractual arrangements with producers whereby they temporarily hold back on production when there is insufficient demand. Secondly, De Beers’ financial strength enabling the CSO to hold a buffer inventory of diamonds until demand improves. Thirdly, De Beers’ marketing campaign designed to stimulate demand for diamond jewellery.

Marketing
In addition to regulating supply, De Beers has also been successful in marketing and creating demand for diamonds. After the 2nd World War, the sales of diamonds had been growing consistently, and marketing campaigns in the USAs and Japan had become very successful. De Beers established the tradition of using diamond rings to seal engagements and popularized the slogan 'a diamond is forever', which was thought up in 1948.\(^{xvi}\) By the early 1960’s, almost 80% of people bought diamond rings when getting engaged. Also in Japan, marketing efforts were responsible for an increase in the use of diamond rings from 5% to 60% between 1966 and 1979. The De Beers marketing campaign also succeeded in West Germany where the Teutonic tradition of two golden bands symbolising undying love was extended to include a third, diamond studded band.\(^{xvii}\)

UNITY OF STRENGTH: BOTSWANA

In the 1950’s, De Beers began prospecting in Botswana. The Orapa kimberlite was discovered in 1967 and the mine commenced production in 1971. Deposits were also discovered and mines opened at Letlhakane and Jwaneng. Debswana was accordingly formed, a company in which both De Beers and the Botswana Government each held a 50% interest. Ownership of the mines vests in Debswana and the Debswana production is also channeled through the CSO. At the time, when Botswana had no track record of
dealings with investors, De Beers Centenary AG\textsuperscript{10} provided Botswana with its first substantial foreign investment.

In a speech by the President of the Republic of Botswana, F. G. Mogae, on the opening of the Orapa 2000 project (which aims to increase Orapa’s annual production), he stated:

\begin{quote}
\textit{“Botswana has consistently supported the orderly marketing of diamonds through the single channel of the De Beers Central Selling Organisation, precisely because we have found that it smoothes some of the natural market fluctuations in sales volumes, prices and revenues. This is more important to us than to other producers, because diamond revenues account for nearly half of all revenues and grants flowing into our national treasury. Even as individuals, we all know that it is very difficult to manage our financial affairs efficiently if our income fluctuates wildly from month to month and from year to year.”}\end{quote}

At independence in 1966, Botswana was one of the world’s poorest nations. In 1999 diamond production was responsible for 75\% of Botswana’s foreign exchange earnings, 65\% of government revenues and 33\% of Gross Domestic Product. In the same year, Botswana was one of the fastest growing economies in the world with a real growth rate of 9\%.

\textbf{BREAKING THE RULES: ISRAEL\textsuperscript{viii}}

During the 1970’s, there had been several increases in the price for diamonds. This was of benefit to the producers who received more for the diamonds than that they sold. At the same time, that the diamond industry was prospering, the Israel economy was struggling and many of the world’s largest diamond dealers established in Israel started investing their money in diamonds. This resulted in the dealers hoarding as many diamonds as they could, and this was fuelled by the banks being prepared to lend money

\textsuperscript{10} The international interests of the De Beers group are held by De Beers Centenary AG.
out at low interest rates. More and more dealers started speculating with the diamonds
and as an increasing amount of diamonds was being held from the pipeline (as much as
20% of total demand for gem-quality diamonds in terms of value), the prices of diamonds
at retail level started escalating. It was clear to De Beers that the bubble would burst and
that diamonds would flood the market and undermine consumer confidence in diamonds.

What made matters worse was that the major producers that were selling diamonds
through the CSO were resenting the fact that there they could receive much better prices
on the market as a result of the speculation. This increased the possibility that producers
might also defect.

In 1977, De Beers intervened and Anthony Oppenheimer was sent to Tel Aviv to inform
the Israeli dealers that it intended to reduce the quantity of diamonds sold to the CSO.
This threat backfired and caused the dealers to buy up even more diamonds from other
sources and pay more for them. Apparently, by 1978, many sightholders could double
their money in one day by simply onselling the parcels allocated to them.

In a further attempt to run down the diamonds that had been stockpiled by the Israeli
dealers, De Beers charged an extra 40 percent on all diamonds that were sold through the
CSO. This made speculation far more risky since the surcharge could be withdrawn at
any time. At the same time, the Israeli banks had been persuaded by De Beers executives
to raise interest rates in respect of loans to diamond traders to market rates. The market
cooled slightly as a result and the temporary surcharges were replaced with a permanent
30% surcharge. The prices for diamonds, nevertheless, continued to rise. In addition,
many Israeli dealers were stripped of their sights. These measures had the intended effect
and having been cut off from more diamonds the Israeli dealers began cutting into their
stockpiles and diamonds. Consequently, Diamond prices fell to normal levels. Although
many dealers had gone bankrupt in the process, the CSO had managed to retain stability
in the industry.
In the 1978 Annual Report, Harry Oppenheimer noted:

“In my statement for 1977 I drew attention to an excessive level of speculation in the market for rough diamonds which had resulted in premiums above CSO prices being paid in secondary markets. These premiums were related to fears about the instability of currencies and the increasing use of diamonds as a store of value. While the use of diamonds as a store of value is, I believe, likely to continue at a higher level than in the past, the trading of diamonds at prices quite unrelated to those that can be sustained in the jewellery market is a threat to the stability of the trade which it is the prime objective of the CSO to maintain”

COLLABORATION: RUSSIANS IN & AUSTRALIA OUT

Although the Russian authorities and the CSO had long established links, De Beers had never been able to control all the diamonds coming from Russia. Reportedly, in the early 1970’s, the Russians had been dumping diamonds on the market. De Beers arranged for a diamond broker to purchase a lot of the excess supply and this retained stability. Nevertheless, in the early 1980’s the Russians again began to flood the market. Apparently 20,000 to 30,000 carats of polished diamonds were initially being exported to Antwerp every month, climbing to 78,200 carats a month. This caused a significant degree of concern in the market and in July 1984 the diamond manufacturers requested De Beers to take whatever measures were necessary to end the sales of the Soviets. In 1985, De Beers announced that it had been informed that “the Soviet Union has no intention of increasing the supply of polished diamonds on the world market and that current price levels will be maintained”. De Beers agreed to purchase a greater quantity of rough diamonds from the Soviets at increased prices and soon afterwards, Soviet polished exports to the market had subsided. xix

Both De Beers and the Russians had been negotiating since April 1994 to discuss modifications to the contract existing at that stage. The company had been expressing
some concern that Russia had been selling diamonds outside of the agreed channels. There had been a large supply of diamonds from the Russian diamond stockpile between the years 1992 to 1997 onto the market. The effect can be seen in figure 4.

This was having a detrimental effect on certain other producers who had been requested to hold back production to 85% of capacity since July 1993. Those producers had been expressing a concern that additional Russian sales had made it impossible for an increase in their delivery entitlement, and also prevented a price increase. The Russian diamond company operating the mines was Almazy- Rossii-Sakha, from which the CSO had purchased diamonds for in excess of US$1 billion in 1994. The contract with the Russian diamond authorities was due to lapse on 31st December 1995 but negotiations for its extension had resulted in a Memorandum of Agreement signed on behalf of Russia and De Beers. Those negotiations centred on Russia’s concern to ensure income from its diamonds against the CSO insisting that supplies of diamonds outside the contractual arrangements should cease. Russia’s desire was to ensure an appropriate supply of diamonds to its cutting industry against the CSO wanting to receive a balanced supply of goods under the sales agreements. The trade agreement existing between Alrosa (formerly Almazy Rossii-Sakha) and the CSO is valid until 31st December 2001.xx

In 1995, the CSO was particularly concerned about the Russian diamonds that had been entering the market through outside channels. This had been happening despite diamond purchases from the Russians of US$1 billion in each of the preceding 5 years. The CSO had sought to prevent excessive flooding of diamonds onto the market by deferring purchases by up to 25%, and later 15%, of contracted sales. Approximately, US$130 million of Argyle diamonds were stockpiled because of these deferrals. Furthermore, in 1995, De Beers realigned its pricing system, but this happened in a way that impacted negatively on Argyle. In 1995, Argyle spokesman Andrew Murray said: “Argyle has certainly been disappointed with the deferred purchases having gone on for so long and we were disappointed with the recent price changes”.xxi In 1996, Argyle announced that it no longer intended to market its diamonds through the CSO.
Exhibit 1 summarises the relationship between the major diamond producers and the CSO.


In 1998 De Beers produced nearly half of the world’s diamond production by value. The world’s total gem diamond production in 1998 was US$6.6 billion. De Beers’ production in South Africa, Namibia and Botswana (US$0.9 billion, US$0.5 billion and US$1.9 billion, respectively) totalled US$3.3 billion. Russia was the major producer other than De Beers with production of approximately US$1.5 billion in 1998. See figure 5 on World diamond production in 1998 and Exhibit 2, which highlights the location of the De Beers Mining Operations.

In 1999, De Beers’ share from its operations in Botswana, South Africa and Namibia totalled US$3 billion and this worked out to 44% of a world production of US$6.8 billion (see figure 6).

In 1998, approximately 2/3 of the annual global supply of diamonds passed through the CSO. Sales of rough gem diamonds were US$3,345 million, which was 28% lower than the previous years sales of US$4,640 million. This was as a consequence of the problematic market conditions that arose from economic difficulties in Japan and South East Asia during the second half of 1997. In these circumstances, the CSO maintained a policy of restricting rough diamond sales. Nevertheless, there is always a short term cost to these measures and the cut in CSO sales contributed to a 40% reduction in the company’s earnings from US$619 million to US$374 million and diamond stocks increased from US$377 million to US$4,816 million. Since there was no significant flow of diamonds onto the market from other sources, the supply of rough diamonds to the cutting centres was below the level of retail consumption and the cutting centres were able to reduce the levels of stock that they held. Once again, the diamond industry was able to adjust to the market without negatively impacting on the price of diamonds and in
1999, sales of rough diamonds by the Diamond Trading Corporation (the company responsible for sales within the CSO) increased by 57% to US$5.24 billion. The action taken by the CSO in 1998 together with the strength of the US market and a recovery in the Asian and Japanese markets contributed to the growth in rough diamond sales. Approximately 44% was mined by De Beers and approximately 20% was brought in from other producers. Therefore, approximately 64% of the world’s diamonds was marketed through the CSO. xxii

**Industry Trends**

Ever since the discovery of diamonds in South Africa at the end of the 19th century there has been, as Rhodes predicted, an increase in the quantity of diamonds produced worldwide. This increase picked up momentum in the 1950’s with the discovery of the Russian diamond fields and escalated with the discoveries in Botswana (Orapa and Jwaneng), Australia (Argyle), South Africa (Venetia) and more recently Canada (Ekati). Figure 7 shows the increase in world diamond production from 1930 to 1998.xxiii

Although the increase in production is largely attributable to De Beers’ production there has also been a significant increase in production from competing producers, such as Ashton, the owners of the Argyle Mine in Australia. Ashton announced in 1996 that it would sell its production directly to the market and not through De Beers. Aggravating matters was the emergence of two powerful competitors in the diamond industry. Rio Tinto owns 60% of Diavik Diamond Mines Inc., which is forecast to produce up to 10% of the world supply by 2003. The other competitor is BHP Diamond Inc., which has a controlling interest in the Ekati mine. This mine currently produces about 5% of the world's gem diamonds and is considered to be amongst the richest deposits. An arrangement has been made between BHP and the CSO in terms whereof it has been agreed that 35 per cent of the Ekati production would be sold to the CSO. Both these mines are based in the Northwest Territories of Canada. On top of this there had been a large supply of diamonds to the market between the years 1992 to 1997 from the Russian diamond stockpile. Clearly this makes it more difficult for other producers to extract value from the diamond market.
There has to some extent been a growth in demand for diamonds that coincided with the escalating diamond production. Between 1985 and 1995 demand grew from approximately US$25 billion to more than US$50 billion. Much of this demand emanated from Japan and the South East Asian economies and reliance was placed on those economies to absorb the increase in production. However, the Asian crisis and decline in the Japanese economy and ensuing decline in the value of local currencies had a severely damaging effect on diamond retailing on those currencies and the decrease in demand, particularly in Japan. This is evident in the figure 9.xxiv

The De Beers diamond price index is testimony to the fact that the CSO has achieved its objective to maintain the price of diamonds notwithstanding the increase in production. In nominal terms, the price of diamonds has only decreased in 1998. When compared to other commodities it can be seen that diamonds are the only commodities to have increased in price in real terms (see figure 10).

There is a degree of consensus in the diamond industry that the philosophy of centralized distribution and inventory management is in the collective interest of the entire market. It is accepted that prices would be more volatile if the CSO did not exist. Before the CSO was formed the revenues of producers were more variable and prices unpredictable. Between 1860 and 1870 prices fell by 50% and producer revenues declined by 89% between 1920 and 1922. What drives the major producers to cooperate is the fact that there are no guarantees that independent selling and marketing will realize higher revenue than selling through the CSO. There are several unknowns in that regard, namely, the types of diamonds mined, the state of the demand cycle and the possibility of outsiders competing for market share. Marketing and financing costs will also escalate and there will be uncertainty about cash flows.

Nevertheless, interests diverge in the short term and there have been producer defections from the CSO ranks. An example is Zaire, which in 1981 decided to market its production separately to Antwerp merchants. The market price of the low grade industrial
diamonds had previously been supported by the CSO stockpile. When this support ceased the demand for the diamonds concerned fell drastically and the price fell from US$3 per carat to less than US$1 per carat. As a result Zaire rejoined the CSO in 1983.

Another, more recent, example relates to the Argyle mine owned by Ashton and the defection referred to earlier. Argyle has however not rejoined the CSO and this defection, coupled with the new discoveries worldwide by competing producers, was beginning to raise questions about decreasing market share and the cost to De Beers of intervention in the market in trying to maintain the prices of diamonds (see figure 11).

The diamond industry was beginning to experience increasing turbulence and many within De Beers felt that the organisation needed to strategically transform itself.

NOTES

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iii. 1 Kanfer, S. Page 61
v. 1 Burne Speech
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vii. 1 Chilvers, 192 -195
viii. 1 Chilvers, 196 -201
ix. 1 Chilvers, 188 - 190
x. 1 De Beers Annual Report 1926
xi. 1 De Beers Annual Report 1929
xii. 1 Address by Sir Ernest Oppenheimer at 1930 Annual General Meeting
xiii. 1 Chilvers, 241
xiv. 1 De Beers Annual Report 1958
xv. 1 Kanfer, 269, 270
xvi. 1 Kanfer, 271
xix. 1 Spar. pp 67- 73
xx. 1 De Beers Annual Report 2000
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APPENDICES

Table 1: De Beers Production for the first ten years, 1889 - 1897

<table>
<thead>
<tr>
<th>Date</th>
<th>Amount Realised</th>
<th>Carats Found</th>
</tr>
</thead>
<tbody>
<tr>
<td>March 31, 1889. Prior to consolidation</td>
<td>901 818 pounds</td>
<td>914 121</td>
</tr>
<tr>
<td>March 31 1890</td>
<td>2 330 179 pounds</td>
<td>1 450 605</td>
</tr>
<tr>
<td>March 31 1891</td>
<td>2 974 670 pounds</td>
<td>2 020 515</td>
</tr>
<tr>
<td>June 30 1892</td>
<td>3 931 542 pounds</td>
<td>3 035 481</td>
</tr>
<tr>
<td>June 30 1893</td>
<td>3 239 389 pounds</td>
<td>2 229 805</td>
</tr>
<tr>
<td>June 30 1894</td>
<td>2 820 172 pounds</td>
<td>2 308 463</td>
</tr>
<tr>
<td>June 30 1895</td>
<td>3 105 957 pounds</td>
<td>2 435 541</td>
</tr>
<tr>
<td>June 30 1896</td>
<td>3 165 382 pounds</td>
<td>2 363 437</td>
</tr>
<tr>
<td>June 30 1897</td>
<td>3 722 099 pounds</td>
<td>2 769 422</td>
</tr>
</tbody>
</table>

Source: De Beers

Figure 1: South Africa: Sales of Diamonds, 1912 - 1945 (% change)

Source: Official Yearbook of the Union of South Africa, Dept of Mines

35
Figure 2: CSO Purchases and Sales, Pre 1998

Source: De Beers

Figure 3: From Exploration to Retailer - The Diamond Pipeline

Source: De Beers
Figure 4: World Production versus World Supply, 1990 to 1998

Source: De Beers
Exhibit 1: CSO Involvement with major diamond producers in late 1990's

<table>
<thead>
<tr>
<th>PRODUCER</th>
<th>INVOLVEMENT</th>
<th>COMMENTS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Angola</td>
<td>No</td>
<td>In October 1999 De Beers ceased purchasing open market Angolan goods, not just in Angola, but any Angolan diamonds that were offered for sale anywhere in the world. The only exception was the SDM mine production from the Cuango Valley which De Beers was contractually obliged to buy. But by December 1999, all De Beers buying offices were closed. Thus, since the end of 1999, De Beers no longer buys any African diamonds and this is after forty years of working in Africa and being involved and supporting the market.</td>
</tr>
<tr>
<td>Australia (Argyle)</td>
<td>No</td>
<td>In 1996 Argyle announced its intention to break away from the CSO.</td>
</tr>
<tr>
<td>Botswana</td>
<td>Yes</td>
<td>De Beers holds a 50 per cent interest in Debswana which operates diamond mines in Botswana. The production is sold through the CSO.</td>
</tr>
<tr>
<td>Canada</td>
<td>Yes</td>
<td>In July 1999 De Beers signed an agreement with BHP to purchase 35 per cent production from the Ekati mine in Canada.</td>
</tr>
<tr>
<td>Namibia</td>
<td>Yes</td>
<td>In November 1994 Namibia and De Beers restructured CDM and renamed it Namdeb - an equal partnership with all diamond mined sold through the CSO.</td>
</tr>
<tr>
<td>Russia</td>
<td>Yes</td>
<td>The trade agreement existing between Alrosa (formerly Almazy Rossii-Sakha) and the CSO is valid until 31 December 2001.</td>
</tr>
<tr>
<td>South Africa</td>
<td>Yes</td>
<td>De Beers mines account for more than 85 per cent of South African production. The production from these mines is channeled through the CSO.</td>
</tr>
</tbody>
</table>
Figure 5: Diamond Production (US$ billion) in 1998

Exhibit 2: De Beers' Mining Operations

Source: De Beers
Figure 6: Estimated Diamond Production (US$ billion) in 1999

<table>
<thead>
<tr>
<th>Country</th>
<th>Production</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia</td>
<td>24%</td>
</tr>
<tr>
<td>Botswana</td>
<td>25%</td>
</tr>
<tr>
<td>South Africa</td>
<td>12%</td>
</tr>
<tr>
<td>Namibia</td>
<td>6%</td>
</tr>
<tr>
<td>Other countries</td>
<td>12%</td>
</tr>
<tr>
<td>Canada</td>
<td>6%</td>
</tr>
<tr>
<td>Angola</td>
<td>9%</td>
</tr>
<tr>
<td>Australia</td>
<td>6%</td>
</tr>
</tbody>
</table>

Source: De Beers

Figure 7: Corporate Structure 1999

Source: De Beers
Figure 8: World Production 1930 to 1998

Source: De Beers

Figure 9: Global Market Share, 1995 - 1998

Source: De Beers
Figure 10: Commodity Prices (Not Adjusted for Inflation, US$)

Source: De Beers, I-net, Deutsche Bank Securities

Figure 11: CSO Sales (thin line) versus Diamond Stocks (bold line), 1968 - 1999

Source: De Beers Annual Reports
Exhibit 3: Major Diamond Resources & Mines

Source: Sunday Times; De Beers
“If the diamond is the hardest substance to scratch, De Beers must be the second hardest”
Stefan Kanfer
Since its formation in 1880, De Beers has been the largest diamond mining company in the world. In 1999 it produced some 44% of the world’s gem diamonds by value from its own mines in South Africa and, in partnership with government, in Botswana, Namibia and Tanzania. It manages twenty mines in these four countries, developing and incorporating all known methods of diamond mining: open-cast, underground, alluvial, coastal and marine.

In May 1990, De Beers was split into two components. International interests of the group are held by De Beers Centenary while South African interests are held by De Beers Consolidated Mines.

De Beers Consolidated Mines Limited owns all the South African diamond mines owned or leased by De Beers. In 1998, the mines produced close to 10 million carats. De Beers Consolidated Mines Limited also owns the interests in the South African portion of the CSO, the South African industrial diamond manufacturers and an investment portfolio.

The Centenary Group owns 50% of Debswana, owned jointly with the Botswana government (19 million carats in 1998), 50% of Namdeb, owned jointly with the Namibian government (1.3 million carats in 1998), the industrial diamond division, contracts for acquisition of diamonds outside De Beers group (including Russia, Angola and 35% of Ekati Mine), companies forming part of the CSO, an investment portfolio and a 6.9% stake in Anglo American.
THE CHANGING LANDSCAPE

Declining Market Share

Ever since the discovery of diamonds in South Africa, at the end of the nineteenth century there has been, as Rhodes predicted, an increase in the quantity of diamonds produced worldwide. This increase picked up momentum in the 1950’s, with the discovery of the Russian diamond fields and escalated with the discoveries in Botswana (Orapa and Jwaneng), Australia (Argyle), South Africa (Venetia) and more recently Canada (Ekati). Figure 1 indicates the increase in world diamond production from 1930 to 1998. Between 1950 and 1985 the world diamond production increased from less than 20 million carats to approximately 60 million carats.  

Supply

Although the increase in production is largely attributable to De Beers’ production there has also been a significant increase in production from competing producers. For example, in 1996 Ashton, the owner of the Argyle mine in Australia, announced that it would sell its production directly to the market and not through De Beers. Prior to that announcement Ashton had cooperated with De Beers and the CSO to retain price stability in the diamond industry. However, in a public announcement the CEO of Ashton stated that he had become impatient with the CSO having deferred purchases of Argyle production and was also dissatisfied with the realignment of the price book by the CSO. These factors prompted the breakaway.

Aggravating matters was the large supply of diamonds to the market between the years 1992 and 1997 from the Russian diamond stockpile. Clearly this made it more difficult for other producers to extract value from the diamond market, and for De Beers to maintain price stability in the market. Figure 2 indicates the impact of the Russian leakage.

Furthermore, there was the emergence of two powerful competitors in the diamond industry. Rio Tinto owns 60% of Diavik Diamond Mines Inc., which is forecast to produce up to 10% of the world supply by 2003. The other competitor is BHP Diamond
Inc., which has a controlling interest in the Ekati mine. This mine produces about 5% of the world's gem diamonds and is considered to be among the richest deposits. (An arrangement has been struck between BHP and the CSO in terms whereof it has been agreed that 35% of the Ekati production would be sold to the CSO.) Both these mines are based in the Northwest Territories of Canada. (Exhibit 1 highlights the major diamond mines worldwide.)

The changing landscape and the emergence of new producers preferring to sell outside the CSO has seen De Beers share of the rough diamond market drop from more than 80% in the 1950’s to approximately two thirds of the world supply of gem diamonds in 1998 and 1999.

**Demand**

There had to some extent been a growth in demand for diamonds that coincided with the escalating diamond production. Between 1985 and 1995 demand grew from approximately US$25 billion to more than US$50 billion. Much of this demand emanated from Japan and the South East Asian economies and reliance was placed on those economies to absorb the increase in production. However, the Asian crisis and decline in the Japanese economy and ensuing decline in the value of local currencies had a severely damaging effect on diamond retailing on those currencies and the decrease in demand, particularly in Japan, is evident from figure 2.

In 1998, De Beers responded to the depressed market in its traditional manner, by restricting the sales of rough diamonds to the market. The objective was achieved yet again - the price of diamonds remained stable through this period, and consumers’ confidence in the stability of diamond investments remained in tact. See figure 3 for the stable and increasing trend of diamond prices as a result of De Beers’ intervention, unlike other commodities.
However, the stability of the diamond price came at a cost to De Beers. There was a 28% decrease in the sales of rough diamonds in 1997 and the size of the diamond inventory increased. At the end of 1998 the stockpile of diamonds was worth US$4.8 billion and that stockpile was not generating a return. Maintaining a stable price for diamonds was an expensive exercise. But De Beers had on several occasions before gone to huge expense to keep the industry in tact. What had become disconcerting, however, was the fact that the size of the stockpile had shown a very clear increasing trend since 1970. This suggested that what was being experienced was not a seasonal or cyclical phenomenon, as it might have been in the past, but rather a structural one (see figure 4 for diamond stock levels). What should have been a temporary buffer against price instability became a more permanent inflated inventory problem. The end result is De Beers takes the brunt when the market is depressed by decreasing production quotas on its mines to restrain supply, impacting negatively on revenues. This in turn gives the other producers the licence to open up and market all their stones – “are we running a charity for them or what?” said Gary Ralfe, De Beers Managing Director in 1999.

**Poor Returns: Market expectation**

Balancing supply and demand in order to stabilise the price of diamonds resulted in De Beers supporting a growing stockpile on the back of their earnings. At the end of 1998, the valuation on the stockpile had ballooned to almost US$5 billion despite production quotas of 74% having been imposed on De Beers’ mines in that year. The diamond account margin of recent years reflects the full impact of these difficulties (see figure 5).

Figure 6 highlights the decreasing return of capital employed, which averaged below 10% through most of the 1990’s, at a level well below the weighted average cost of capital. This level of low profitability and poor return to shareholders has meant that the markets have held De Beers shares at an under performing rating for most of the past decade. This falling trend in the company's share price (see figure 7) has seen it fall in real terms and consistently under performing key stock indices.
Only twice in the past twenty years, 1980 and again in 1989, were attributable earnings more than US$ 1 billion. In the words of Gary Ralfe, at an investors presentation in Dublin 1999, this earnings performance over the past decade has been somewhat ‘pedestrian’ and “certainly not something that can give us great pleasure’. The need to create and enhance shareholder value was stated as being of essential focus for De Beers’ new management.

The makeup of the shareholders of De Beers has changed to a fifth of all shares now being held in US mutual funds. This change in ownership structure came about after the Asian crisis, which depressed CSO sales and slashed De Beers’ earnings and share price. The American investors saw a weak share price that was trading at an attractive discount to Net Asset Value. They expected strong growth with good market returns in the short-term, and ultimately perceived the swollen stockpile as a non-performing asset and a destroyer of wealth. They did not see the stockpile as one of the central components of De Beers’ single channel distribution strategy to maintain stable prices for diamonds. The successful implementation of this strategy is in the interests not only of other producers but also of De Beers as the major producer. However, despite the successful track record of this philosophy, Nicky Oppenheimer recently acknowledged that “diamond stocks built up in 1998 were excessive and value destroying as far as De Beers shareholders were concerned.”

The new management team of Nicky Oppenheimer as Executive Chairman and Gary Ralfe as managing Director brought a fresh impetus to the struggling De Beers. According to Gary Ralfe “It coincided with a bummer of a year in business. It was the worst possible year – 1998, just after the Asian crash, and it didn’t take me very long to realise that in fact it wasn’t just one bum year. We’d been having a succession of difficulties.” iv
CREATING THE FUTURE: AN INTERNAL PERSPECTIVE

Searching for Direction

In 1996, around the time that De Beers and Anglo American Corporation decided that the management functions of the two companies should be split, the then Operations Manager at De Beers, Brian Ainsley, had been running a strategic planning process involving senior operations personnel. Certain issues emanated from these meetings.

One of those issues was the concern on the part of the Operations Division that there was not enough interaction between the sales and marketing side of the business and the operational side. Coupled to this was a degree of uncertainty about the future of the diamond industry and De Beers’ role in the industry, particularly in light of the declining market share sparked off by the Russians leaking diamonds onto the market and the defection of Argyle. This was making it increasingly difficult and expensive for De Beers to control the dynamics of the marketplace. The uncertainty was also making it difficult for the operations leadership in the organisation to communicate the production goals to the various mining operations.

Oxford Seminars

The concerns were communicated to the Chairman and Managing Director in 1998 and towards the end of that year it was decided that the London Executive Committee (which was concerned primarily with sales and marketing matters) and the Johannesburg Executive Committee (which was typically engaged with operational matters) should be brought together. It was decided that Templeton College in Oxford would be the appropriate venue for this to happen and for the Senior Executives to start discussing certain strategic issues. At that meeting, there was a fair degree of discussion surrounding shareholder value, with some input from the Corporate Finance department at Oxford University, and some concerns were raised about the dropping of the De Beers share price in real terms.
Bain & Co. Climb on Board

The idea of a strategy for De Beers on a global scale was discussed after this seminar and it was agreed that a team of Bain consultants should attend one of the future Oxford seminars. From then on Bain became integrally involved in the review process. With the help of Bain, Gary Ralfe felt that the new management team would be better equipped and better able to liberate “the intellectual vigour that existed, suppressed, in all reaches of the company” and also because Bain would provide the company with an “uncomfortable ride”. Subsequently, commenting on Bain’s involvement in the review process, the Managing Director has remarked that “they have given us a rough ride ….there’s been a phenomenal momentum that has gathered pace. With this review, I have to admit there were times when I said, ‘My goodness, I’ve let a genie out of the bottle and I can’t put it back in.’”

Guiding Coalition

According to Gary Ralfe the senior management of De Beers have been involved in strategic reviews before but what distinguished this particular review was the involvement of more people working for the company. With the strategic review a new committee was formed which was initially called the Super Exco but later the Strategic Task Team, and is comprised of all the De Beers executive directors as well as a number of influential “change agents” in the company. This committee is essentially the guiding coalition of strategic change and meets ten times in varying locations, namely, London, Johannesburg, Lucerne and Kimberley. As will be explained in more detail later the three major pillars of the review are Supplier of Choice, As is Plus and Branding Opportunities. The heads of each business unit that were affected by the review took ownership of and became responsible for driving the implementation of the review in their respective areas. Broadly, the Supplier of Choice and Branding Opportunities pillars impacted mainly on the sales and marketing divisions of the company, and the As is Plus leg predominantly on Operations.
The strategic review mission statement that emerged was “the need to focus on creating and enhancing stakeholder value and especially shareholder value” and this became the driving force of future debates and conclusions. One of the conclusions of the strategic review exercise was that “to preserve its economic success the Diamond Trading Company (the company responsible for sales within the Central Selling Organisation) must become demand driven and not supply led. Through its scale and network the DTC must re-energise the entire global industry to reinvest in diamond jewellery as a category.”

Communication and Buy In

The new vision for De Beers was communicated across the organisation through the company intranet, manual inhouse publications and management committee meetings. An electronic survey has been conducted across the organisation giving respondents an opportunity to anonymously state whether they agree, disagree or are neutral about the effectiveness with which the strategic plan had been communicated. Most of the responses came back neutral. In the same survey similar questions were asked about direction, performance, empowerment and leadership issues related to the strategic review and the responses were similarly neutral. James Campbell, the Professional Assistant of the Chairman, e-commerce Manager and one of the influential change agents within the company, has acknowledged that it has been challenging to get buy in to the review from all the stakeholders. In his words “you can’t change the direction of an oil tanker overnight”. This applies also at a senior level. At one of the Templeton seminars a De Beers executive director, who has since retired but who had worked for the company for in excess of forty years, gave a presentation on the history of the company, tracing its ups and downs. He concluded that the company was not in decline prior to the review and that what was being experienced was just part of the cycle. Although he was not opposed to the review he thought that the whole thing might be a bit of a storm in a teacup. Figure 8 highlights the Organisational structure at the Executive level in De Beers.
THE STRATEGIC REVIEW

The Objectives: The scope of the review

The Mission Statement for De Beers Strategic Review was defined as "The need to focus on creating and enhancing stake-holder value, especially, shareholder value". As mentioned earlier the review came about as a result of a number of factors but was instigated primarily by the below par performance of De Beers share price in the 1990's. The initial objectives of the Strategic Review were laid out in the Managing Directors review of 1999 as being:

- To analyse the financial performance of De Beers diamond operations over the past decade;
- To gain a deeper insight into the diamond industry pipeline and to consider how to respond to increased competition;
- To look for insights in parallel industries;
- To determine a set of strategic options;
- To identify actions immediately to improve shareholder value

The reach of the strategic review would extend into the most important facets of the De Beers business, from exploration and research, to operational, and on down to marketing. It would also encompass an in-depth study of the current business model. The term ‘no sacred cows’ was used by executives to reinforce the fact that all business units would be evaluated on their current worth, their future importance to the core strategy, and their impact on profitability to the group.
THE STRATEGIC PLAN: SUPPLIER OF CHOICE

The end of its role as custodian

The decision by De Beers to transform itself from keeper of the diamond cartel to the largest company in a more competitive diamond market may have been inevitable with rising competition in both mining and the marketing of rough gems. Hailed as one of the most significant developments in the diamond industry since the 1930s, De Beers announced the end of its role as custodian of the diamond industry on the 12th of July 2000 to a gathering of its leading clients (sightholders). Figure 9 indicates the 3 major initiatives that were implemented from the Strategic Review.

According to Gary Ralfe “’Supplier of Choice’’” is all about trying to establish a more robust and committed partnership between ourselves and our clients, and at the same time to generate greater expenditure on advertising- with a proliferation of brands, we hope, because that generates adspend itself-in order to drive additional demand for jewellery”. This will fundamentally change the way De Beers conducts its business in the future. The crux of the strategic plan is to drive incremental growth in the retail market. Therefore instead of focussing on controlling the supply of rough diamonds entering the market, De Beers will now seek to develop a number of initiatives to drive consumer demand. The conclusion of the strategic review in August 1999 was that “to preserve its economic success, the DTC must become demand driven and not supply led. Through its scale and network the DTC must re-energise the entire global industry to re-invest in diamond jewellery as a category”. Since the inception of the CSO, diamond sales have grown at merely the rate of global economic output. Now De Beers would like that to grow in line with sales of other luxury goods, which attain compounded annual growth rates in excess of 7%. In the words of Gary Ralfe, “there’s a huge untapped opportunity for all of us in the industry to grow the diamond business and match the growth rates enjoyed by leading luxury goods companies. That sector has demonstrated that brands are a catalyst for growth”. In this regard there is a big disparity between the amount of money spent on advertising in the diamond industry and in other luxury items industries.
Figure 9 shows the percentage of revenue spent on advertising across a number of sectors.

De Beers has already shown its potential for increasing demand with the millennium marketing campaign. The campaign focussed on America and Europe and sought to persuade consumers that there was an association between the dawn of the new millennium and diamonds. The campaign was highly successful and increased diamond demand by between US$300 million and US$400 million at the end of 1999. Exhibit 2 indicates one of the advertisements used by De Beers as part of the millennium marketing.

In order to increase demand for diamonds at retail level De Beers will strive to alter its business model of acting as the buyer of last resort to one geared to boosting sales of gems through more effective marketing, by also formalising its relationship with the sightholders and by trying to exclude conflict diamonds from the diamond value chain.

The leading building blocks of the Supplier of Choice strategy are a package of value-added services to drive efficiencies through the diamond pipeline, the establishment of a code of professional and ethical standards, a policy statement and a powerful new identity in the DTC.

**Partnerships for the 21st Century: The sightholders**

Firstly, De Beers will formalise the relationship between the company and their favoured ‘sightholders’, the collection of cutters and polishers who buy De Beers rough stones and turn them into sparkling gems for retail sale. This will see written contracts replace the verbal arrangements that had previously existed between De Beers and the sightholders. There will be a focus towards the vertically integrated, larger sightholders/clients who will be able to actively market their own products. It is anticipated that the industry will consolidate down from the current 125 sightholders with marginal players being squeezed out of the marketplace. The well-capitalised sightholders are perceived to be more efficient, which should have positive repercussions by shortening the diamond
pipeline and allowing for better inventory and tighter stock management along the supply chain. There will also be an increased emphasis on marketing and distribution and sightholders will be encouraged to have business plans that cater for marketing initiatives.

“To grasp the opportunity for long-term growth, we need to transform the way we do business. We want to work in partnership with our clients – our sightholders – to create a dynamic, competitive and customer focused diamond industry. This ‘Supplier of choice’ strategy will put our business in a more robust position to face the challenges of the twenty-first century,” Gary Ralfe said at the announcement of the strategic plan.

With the help of the downstream retailers, De Beers wants to lift global adspend on marketing from today's one per cent of retail sales, up closer to the ten per cent of sales typical for other luxury-goods business. And while sales of high-end luxury items like watches and leather goods are predominately branded, only a meagre 13% of total retail gems sales are branded. "While our core business will remain the mining and marketing of rough diamonds, in five years time we envisage an industry in which there are multiple and competitive brands. As we learned from the other industries, competing brands stimulate global demand. In due course, we hope that the De Beers brand will be one of those," concluded Gary Ralfe at the unveiling of the Supplier of Choice programme.

The DTC will offer the favoured sightholders an extensive package of value-added support services to assist them in developing an advertising and promotion strategies. The support service will equip them to drive consumer demand, includes training, marketing and business planning solutions, market research and information, and a pipeline wide extranet.

The Diamond Trading Company and a Powerful New Identity
A powerful new identity will be established under the Diamond Trading Company. The DTC will attempt to drive up demand for diamonds and will be supported by the De
Beers marketing campaign. De Beers has looked for strong imagery and decided to harness the internationally recognised slogan ‘A Diamond is Forever’. The new identity will reinforce the DTC sightholders as the leading diamantaires of the world operating within globally recognised distribution channels. This distribution strategy has been put in place to move diamonds to the high street jewellery stores through safe (conflict free and guaranteed) channels, via vertically integrated sightholders in unison with the DTC brand.

**Best Practice Principles**

A set of principles has been designed to ensure that best practice is observed in the diamond industry and providing consumers with confidence of the ethical standards of the diamond industry. The De Beers Group has committed itself to abiding by these principles and is trying to ensure adherence to the principles as far down the value chain as possible. That is why the supply of diamonds to sightholders is conditional upon those sightholders agreeing to be bound to these principles. The principles are geared towards issues such as:

- Consumer confidence and ensuring that people who buy diamond jewellery are able to rely on the ethical standards of the people operating in the industry, particularly in light of the fact that the consumer usually has limited knowledge about diamonds.
- Commitment towards ensuring that unacceptable business practices such as to purchasing of conflict diamonds are avoided.

**Policy Statement**

A policy statement has been issued which sets out criteria for sightholders in regard to the most effective distribution and marketing practices. This policy statement will help De Beers improve its ability to supply the right diamonds to the leading diamantaires best able to distribute and market them most efficiently. The impetus will be the move away from controlling supply and fixing prices to driving demand through greater focus on
marketing and branding. It is hoped that this will encourage growth of the diamond business in the long term.

**STRATEGIC PLAN: AS IS PLUS**

‘As is Plus’ is one of the three pillars of the strategic review and was the first initiative to be implemented across all De Beers’ Operations. It is primarily a cost reduction programme that is being driven by the new Operations Director Gavin Beevers. The programme goal has been stated as “continued restructuring of the mining operations to improve utilisation of assets and operating efficiencies”. This particular pillar of the review is focussed at reducing or eliminating the inefficiencies that have crept into the mining operation, as is quite typical of large, high margin businesses. According to Gary Ralfe the BHAG in regard to the As is Plus programme is to cut US$900 million out of group costs.¹⁸

When the As is Plus programme was implemented it meant ‘achieving the same with less’. The initial target was to save 15% on expenses that came to almost US$1 billion in 1999. In that year there was a reduction in exploration costs of US$42 million from US$104 million in 1998. One year later, according to Debmarine’s General Manager Paul Dixon-Savage, there has been a shift away from pure cost savings and the focus has evolved to ‘achieving more with the same’.

In reflecting on the first year of the As is Plus initiative Gavin Beevers was of the view that the group needed to realise savings but must also produce more and that the operations must continue to explore avenues of production optimisation and strive for continuous operations. With regard to the relationship between Operations and Sales he believes that operations must strive to deliver what the sales division requires of it and that sales must strive to sell what the operations division delivers.
STRATEGIC PLAN: BRANDING OPPORTUNITIES

De Beers has started exploring alternatives to generate additional revenue from the De Beers brand. An industry has been envisaged in which there will be multiple, competing diamond brands. This will benefit the entire industry because competing brands stimulate demand in the market. De Beers sees itself as a dominant competitor in a more competitive market and still hopes to retain the majority of the rough diamond market share. But this requires that it start considering ways to maximise the inherent value of the De Beers brand. De Beers has already to a small degree demonstrated the inherent potential of the brand by etching the De Beers logo into certain diamonds that were sold as millennium gems. This experiment proved to be a phenomenal success but De Beers has not committed itself fully to the notion for fear of alienating downstream partners whose sales of unbranded gems might be compromised as a result of the De Beers branded diamonds. The possibility of alienating other participants in the diamond industry notwithstanding, there is increasing pressure on De Beers to start exploiting its brand because rivals such as BHP are already experimenting with branding.

De Beers have announced that a team, helped by Bain, has been tasked with formulating a business plan for branding. Although the strategy on branding is not entirely clear at this stage there has been some speculation on the part of analysts. The speculation has been fuelled by remarks from De Beers director Tim Capon that the company might even consider buying a business that sells things such as watches or handbags. The company might enter new markets. Andrew Jackson of Deutsche Bank Securities has suggested that De Beers should consider transferring control of the De Beers brand to a third party to realise its potential. One of the benefits of this suggestion is that it will simplify marketing in the United States by interposing a third party between the company and the United States anti-trust authorities. Jackson says that Deutsche Bank “favours a model in which an independent company is established with a strategic senior partner to exploit the brand. We envisage a global luxury goods company with a strong jewellery business to be the ideal partner.”
GROWTH PROSPECTS: TO INCREASE MARKET SHARE

De Beers as part of its new strategy is hungry to make major investments as it seeks to broaden its geographical activities to dilute its reliance on its southern African operations in South Africa, Botswana and Tanzania. This means buying mines and potential mineable projects in other regions of the world and directly controlling a larger slice of world diamond production. De Beers currently markets about two thirds of world production, but mines only about 44% of the world's diamonds. Expansion of self-controlled production was highlighted as a key issue in De Beers' strategic review.

Cecil Rhodes, who founded De Beers in 1888, once told shareholders, "When you hear that a new mine has been discovered, if De Beers is not there, they are very near the spot". When Rhodes made this remark, De Beers had all of its mines in Africa. On the day De Beers announced its strategy for the 21st century that was still the case.

However within weeks of the announcement, De Beers confirmed its new stance with a pair of takeover bids. One was for Winspear Diamonds Ltd. of Canada, which has the Northwest Territories diamond property of Snap Lake. It is expected to produce about 10% of the world's diamonds by 2010. De Beers successfully secured its first operational foothold outside of Africa with the acceptance of its US$206 million offer for Winspear. De Beers could invest C$269 million to develop the mine, which is expected to start up in December 2002 and is forecast to produce approximately 1.8 million carats annually.

The other bid was for Ashton Mining Ltd. of Australia, which owns 40% of the Argyle Mine, the world's largest diamond mine. On 13th November 2000 a De Beers spokesperson stated, however, that the offer for Ashton was unlikely to succeed. De Beers’ bid had been higher than the rival bid from Rio Tinto but the Malaysian Mining Corporation (which owns a 49.82% share in Ashton), accepted the offer from Rio Tinto, apparently because the Malaysian investors were getting impatient at the delay experienced by De Beers in getting regulatory approval from Australia and Belgium.
In 2000 De Beers also spent R4.2 billion on purchasing the 50% share of the Venetia mine that it did not already own. In addition to this investment there are certain plans for South African production, including the Combined Treatment Plant in Kimberley in the Northern Cape which aims to rewash all the mine tailings in and around Kimberley, and the extension and deepening of the Finsch Mine in the Northern Cape and Premier Mine in Pretoria, respectively.

FIRST RESULTS BEGIN FILTERING THROUGH

The company's new strategy got off to a strong start in its first year when the company announced a tripling of first half earnings following record gem sales. Strong global demand, in particular robust US retail demand, the health inventory drawdown and increases in De Beers' own selling prices lifted headline earnings to US$877 million from US$269million in 1999.

On 31 March 2000, Gary Ralfe stated that the company had set itself the target of selling no less than the US$5.24 billion that was sold in 1999. Five months later it appeared that the company was well on the way to achieving that objective. By August 2000 the stockpile had been dramatically reduced to US$2.712 billion (very close to the new target level of $2.5 billion) on the back of record first half sales for 2000 of US$3.517 billion. "These are a set of excellent results….The strong cashflow gives us the opportunity to look at investing further in the diamond business," said Nicky Oppenheimer.

NOTES

i. Presentation by Gary Ralfe- De Beers Managing Director at Merrill Lynch Metals and Mining Conference, Dublin, 12 May 1999
ii. Presentation by Gary Ralfe, 12 May 1999
iii. Presentation by Gary Ralfe, 12 May 1999

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v. A Fighter for the Diamond Business
vi. Telephonic interview with James Campbell on 3 November 2000
vii. Chairman and Managing Director’s Circular to all De Beers staff- 28 June 2000
ix. De Beers wants to be ‘supplier of choice’ Sunday Times Business times March 12 2000
x. Gill A. 2000, “De Beers Results lend shine to its global strategy”, Sunday Times, Business Times, August

BIBLIOGRAPHY


5. Deutsche Morgan Grenfell Report- De Beers, Reading Between the Lines (10 September 1999).


9. August 1st.


APPENDICES

Figure 1: Growth in World Production, 1930 to 1998

Source: De Beers

Figure 2: Production versus Supply

Source: De Beers
Exhibit 1: Major Diamond Resources & Mines

Source: Sunday Times; De Beers

Figure 2: Global Jewellery Sales, 1995 - 1998

Source: De Beers
Figure 3: Commodity Prices (Not Adjusted for Inflation, US$)

Source: De Beers, I-net, Deutsche Bank Securities

Figure 4: Diamond Stock Levels

Source: De Beers; Deutsche Morgan Grenfell (Andrew Jackson)
Figure 5: Diamond Account Margin

Source: De Beers; Deutsche Morgan Grenfell (Andrew Jackson)

Figure 6: Return on Capital Employed, 1998 to 1998

Source: De Beers
Figure 7: De Beers Share Price

Source: I-net
Figure 8: Organisational Structure

Source: De Beers
Driving greater demand by working more closely with our sightholders.

Seeking ways to develop multiple brands, including de Beers, to drive significant additional demand.

Significantly improving operating efficiencies & economies.

Source: De Beers
**Figure 9: Percentage of revenue spent on advertising**

Source: De Beers; Deutsche Morgan Grenfell (Andrew Jackson)

**Exhibit 2- Millenium Campaign Advertising, 1999**

*Source: De Beers*
Table 1: Income Statement & Balance Sheet DBCM

### Exhibit##: De Beers Consolidated Limited Income Statement

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*Source: De Beers*

### Exhibit##: De Beers Consolidated Limited Balance Sheet

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*Source: De Beers*
### Table 2: Balance Sheet & Income Statement DBC

#### Exhibit ##: De Beers Centenary AG Balance Sheet

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#### Exhibit ##: De Beers Centenary AG Income Statement

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Source: De Beers
Figure 10 - Corporate structure

Source: De Beers

Figure 11 Margins across Pipeline

Source: De Beers
Exhibit 3: Large Pipeline drawing

Source: De Beers
Exhibit 4: De Beers mine Map, 1999

Source: De Beers

Figure 12: De Beers Production, 1989 to 1998

(Million Carats)

Source: De Beers
INSTRUCTORS GUIDE - DE BEERS: STABILITY IN THE DIAMOND INDUSTRY 1880 TO 1999

INTRODUCTION

The primary aim of De Beers: Stability in the Diamond Industry is be to demonstrate how originally Rhodes and then De Beers have managed the structure of the industry and the relationships between the major producers in the diamond industry so as to benefit De Beers itself as well as the industry as a whole. The relationships have been converted from a form of competition, which would adversely affect the industry, to a form of competitive collaboration that ensures that the prices of diamonds are maintained and the industry survives.

The case also serves as an illustration of the trends and market signals that emanated from key producers in the industry and to gain an understanding of those trends and signals in the context of the diamond industry and their potential impact on De Beers and the industry at large.

The three questions that could be asked in respect of this case study are as follows:

Question 1- Discuss the structural factors that have enabled De Beers to gain and retain a dominant position in the diamond industry. How else has De Beers managed to retain dominance?

Question 2- To what extent can Game Theory be used to explain De Beers’ strategies to create a win-win situation for all the dominant producers in the industry?

Question 3- Identify the market signals and trends that were beginning to raise questions about the ongoing effectiveness of the single channel distribution strategy. Analyse their consequences.
The first question will require students to reflect on the diamond industry and what characteristics of the industry have facilitated De Beers’ ability to gain and retain dominance. The students will then be required to consider the factors internal to De Beers and the structures set up by De Beers that have kept De Beers in a dominant position.

In order to answer the second question the students will have to familiarize themselves with the basic principles of Game theory. Brandenburger and Nalebluff, in discussing how the game can be changed, refer to several aspects of the game. Each of these can be applied to the case study and this will give students a valuable practical example of how Game Theory can be applied in business.

The third question will require that students identify the trends as well as market signals coming from other competitors, and then analyse the implications for De Beers. This discussion will prepare the students for the **De Beers’ Strategic Transformation** case.

**READING LIST**

The following readings will serve as important preparatory reading material:

2. Brandenburger A and Nalebluff B: Co-opetition in *Co-opetition*
3. Brandenburger A and Nalebluff B: Game Theory in *Co-opetition*
4. Brandenburger A and Nalebluff B: How to Change the Game in *Co-opetition*
QUESTION 1

Discuss the structural factors that have enabled De Beers to gain and retain a dominant position in the diamond industry. How else has De Beers managed to retain dominance?

STRUCTURAL FACTORS

According to Debora Spar economists have identified five structural factors that are important in determining formation of producer cartels.

<table>
<thead>
<tr>
<th>Structural Factor</th>
<th>Effect</th>
</tr>
</thead>
<tbody>
<tr>
<td>High concentration of production</td>
<td>The fewer producers in the marketplace the easier it is for them to come together with a view to cooperating.</td>
</tr>
<tr>
<td>High barriers to entry</td>
<td>If it is easy for outsiders to gain entry into the industry there is a significant threat of production entering the market- this threatens price stability.</td>
</tr>
<tr>
<td>Small fringe</td>
<td>These are producers that are not regarded as having sufficient power to become a member of the cooperative alliance. The fewer of them the less chance there is of them having a collective impact on price stability.</td>
</tr>
<tr>
<td>Nonsubstitutability</td>
<td>If consumers are easily able to find substitutes as prices rise it will be more difficult for producers of the substituted goods to effectively manage the market.</td>
</tr>
<tr>
<td>Nondifferentiation</td>
<td>Producers cannot engage in nonprice competition while still maintaining noncompetitively high prices.</td>
</tr>
</tbody>
</table>

Applying the first four of these forces (and also including the bargaining power of buyers) to De Beers the following comments can be made:
<table>
<thead>
<tr>
<th>Structural Factor</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>High concentration of</td>
<td>At the outset, in Rhodes’ era, when production was limited to mines in South Africa, it might have been somewhat easier to control prices by controlling production. But the trend towards increasing production worldwide has made it more and more difficult and expensive for De Beers to effectively maintain price stability in the industry. This is evident from the growing stockpile, the details whereof are reflected in Case A.</td>
</tr>
<tr>
<td>production.</td>
<td></td>
</tr>
<tr>
<td>High barriers to entry.</td>
<td>The most lucrative diamond deposits to mine are the kimberlite pipes, as opposed to alluvial deposits. However, the capital expenditure required for setting up the infrastructure and mining kimberlite deposits is massive, varying in accordance with the size of the deposit. As an example, it cost $300 million to double the capacity of the Orapa Mine from 6 million to 12 million carats. On top of this there is the exploration expenditure - for De Beers in 1998 this amounted to $104 million.</td>
</tr>
<tr>
<td>Small fringe</td>
<td>The larger the fringe becomes the more of an impact they can collectively have on De Beers ability to retain stability in the marketplace. However, De Beers used to cater for fringe production as the buyer of last resort, buying up surplus production in the marketplace. This requires huge financial resources.</td>
</tr>
<tr>
<td>Nonsubstitutability</td>
<td>Rubies, emeralds, sapphires and so on have never threatened the dominance of the diamond as a gem.</td>
</tr>
<tr>
<td>Bargaining power of</td>
<td>The bargaining power of the sightholders has traditionally been low because the CSO is the major supplier of rough diamonds to the market. If sightholders irritate De Beers with excessive demands they run the risk of not being invited back to following sights.</td>
</tr>
<tr>
<td>buyers</td>
<td></td>
</tr>
</tbody>
</table>
COOPERATION

However, Debora Spar points out that, although the structural factors might go some way towards explaining the circumstances in which a cartel can successfully operate, there is also the importance of co-operation. And cooperation from other stakeholders is one of the pillars of De Beers’ success. Essentially it is cooperation from other producers that has enabled De Beers to manage price stability by controlling the supply of diamonds to the marketplace. Initially, it was easier to control production and this made it easy to control supply. As other producers started emerging, however, it became increasingly difficult to control production and efforts were geared at controlling supply by entering into cooperative arrangements with those producers whereby they agreed to sell their production to the CSO.

Cooperation from other producers became increasingly important with the escalation of discoveries from the 1950’s onwards, commencing with the discovery of diamonds in Russia and then later in Botswana and Australia. The industry is threatened when other producers break off their cooperative ties with the CSO, for example, Argyle in 1996. The value and importance of the Russian arrangement has also always been acknowledged by De Beers. Essentially as it became more difficult to control production the importance of cooperation from other producers in regulating supply to the marketplace escalated. Diagrammatically this can be illustrated as follows:
CONTROL STRUCTURES

*Cecil John Rhodes- Control of Supply through control of Production*

Since the discovery of diamonds in South Africa and the resulting potential for them to become commodity items, it has always been important to maintain the illusion of scarcity in the mind of the consumer. The diamond market has always been vulnerable to price fluctuation, depending on supply and demand. Price fluctuation, however, would result in diamonds losing their allure as scarce items in the mind of the consumer and would be extremely damaging to the price of diamonds, to say the least. That is why it has always been important to control the supply of diamonds to the marketplace in order to ensure that demand does not exceed supply, as this would cause the prices of diamonds to decrease.
When Rhodes entered upon the scene the industry was very fragmented with 3600 claims being in the hands of 98 syndicates. There was a lot of competition and very little cooperation and this was resulting in an oversupply of diamonds to the market, causing diamond prices to fall and many mines to be put out of production. Originally, supply to the market could be controlled by control of production. The objective of Rhodes was always “the adaptation of the supply of rough diamonds to the market dependent world by means of centralizing the control of production”. Case A sets out the steps taken by Rhodes in order to gain control of the industry. This involved first gaining control of the De Beers mine in Kimberley and later the Kimberley Mine.

Proof of the success of this strategy are contained in the pronouncements of Barney Barnato in the 1889 Board Meeting of De Beers, subsequent to the amalgamation, when he stated that the amalgamation had justified itself and that the price of diamonds had increased from 20 shillings per carat to 30 shillings.

**Ernest Oppenhiemer- extending control down the Supply Pipeline**

Although it was important to gain control of production, the discovery of the Premier Mine, the Lichtenburg alluvial deposits and diamonds in the then South West Africa made this more difficult. These discoveries threw the diamond industry into a crisis because of the dramatic increase in the supply of diamonds to the market, which had increased almost fourfold (from 1 854 000 pounds per year to 6 528 000 pounds per year). In order to prevent an oversupply of diamonds to the market the London Diamond Syndicate, which at that stage was an organization that operated independently of De Beers, bought up all surplus production. Sir Ernest recognized the importance of the producers having a voice in the disposal of these diamonds because the diamonds were of a type that brought them into competition with De Beers production. He accordingly took steps to gain control of the London Diamond Syndicate, which had evolved into the modern day CSO. Control was accordingly extended further down the pipeline.
The CSO became the vehicle used by De Beers to regulate the supply of rough diamonds to the marketplace. This was done by taking the following measures:

- Seeking cooperative arrangements with other producers in the industry whereby it was agreed that supply would be channeled through the CSO,
- In certain instances, in times of depressed markets, the producers that were selling their production to the CSO could be requested to hold back on production (including the De Beers mines. For example during the Depression the De Beers mines ceased production entirely).
- The CSO acting as buyer of last resort and buying up all the surplus diamonds on the marketplace. Huge financial resources are obviously required to implement this and contributes to inventory problems but these measures have saved the industry from collapse in the past, witness for example Lichtenburg and the Russian leakage of diamonds onto the marketplace in the 1980’s.
- In the event of a surplus of diamond supply, stockpiling diamonds until conditions improve.
- Using the CSO to tap into market demand as far as consumer trends are concerned and supplying diamonds accordingly.

QUESTION 2
To what extent can Game Theory be used to explain De Beers’ strategies to create a win-win situation for all the dominant producers in the industry?

“Game theory provides a systematic way to develop strategies when one person’s fate depends on what others do”- Brandenburger and Nalebuff in Coopetition.

Enlarging the pie
Game theory is a useful way of understanding the nature of the relationships among players in a business environment. In any situation there is potential for conflict and
potential for co-operation. McMillan likens the situation to dividing a pie. All of the players want the pie to be as large as possible but when it comes to dividing the pie they all want their slice to be as large as possible. But in striving to maximize individual slices of the pie, players might be diminishing the size of the entire pie. So there is a tension between seeking a large slice and a large total pie.

All diamond producers are the players in this instance. In the beginning Rhodes noticed how all the producers kept producing without regard to their output and simply to achieve maximum profit. In 1876 there were 3600 claims in the hands of 98 syndicates. He noticed how this was adversely impacting on the price of diamonds as a result of oversupply. He realized that if this continued it would result in a lose-lose situation for all competitors. The slice of the pie would be diminished because the prices of diamonds would fall as a result of oversupply. Thus he saw that individuals striving to maximize individual share of the pie would diminish the size of the entire pie.

Rhodes managed to enlarge the pie by gaining control over production and accordingly regulating the supply of diamonds to the marketplace. This resulted in an increase and maintenance in the price of diamonds and, accordingly, an increase in the size of the pie. This increased the attractiveness of the industry and existing and potential diamond producers could benefit from the steps taken by Rhodes to maintain the prices of diamonds.

Subsequent to Rhodes, De Beers has been able to maintain and increase the size of the pie through the Central Selling Organisation structure set up by Sir Ernest in the 1930’s. This has been made possible by the following:

- Seeking cooperative arrangements with other producers in the industry whereby it was agreed that supply would be channeled through the CSO,
- In certain instances, in times of depressed markets, the producers that were selling their production to the CSO could be requested to hold back on production (including
the De Beers mines. For example during the Depression the De Beers mines ceased production entirely).

- The CSO acting as buyer of last resort and buying up all the surplus diamonds on the marketplace. Huge financial resources are obviously required to implement this and contributes to inventory problems but these measures have saved the industry from collapse in the past, witness for example Lichtenburg and the Russian leakage of diamonds onto the marketplace in the 1980’s.

- In the event of a surplus of diamond supply, stockpiling diamonds until conditions improve.

- Using the CSO to tap into market demand as far as consumer trends are concerned and supplying diamonds accordingly.

**Co-opetition**

The importance of cooperation increased with the advent of new discoveries and new producers. If De Beers could not gain control of production it would at least have to ensure that the other major producers channeled their supply through the Central Selling Organisation, established by Sir Ernest in the 1930’s and designed to regulate the supply of diamonds to the market in order to retain stability of prices.

In this regard, competitors realize that they can do better for themselves by co-operating. Together they can dominate the market and dictate price consumers must pay. There are disadvantages can be listed as follows:
<table>
<thead>
<tr>
<th>Sacrifices</th>
<th>Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commission on sales paid to CSO thus reduced income</td>
<td>Price stability and regular price increases</td>
</tr>
<tr>
<td>Prohibited from selling through any other channel</td>
<td>Guaranteed purchases, but subject to quotas in some instances</td>
</tr>
<tr>
<td></td>
<td>Publicity for diamond jewellery</td>
</tr>
<tr>
<td></td>
<td>Market research</td>
</tr>
<tr>
<td></td>
<td>Experience in sorting, valuing and marketing of diamonds</td>
</tr>
<tr>
<td></td>
<td>Marketing structure already established</td>
</tr>
</tbody>
</table>

Botswana is an ideal example of a country that has benefited from cooperation. At independence in 1966 Botswana was one of the world’s poorest nations and in 1999 Botswana was one of the fastest growing economies of the world with a real growth rate of 9 per cent. In 1999 Diamond production was responsible for 75 per cent of Botswana’s foreign exchange earnings, 65 per cent of government revenues and 33 per cent of gross domestic product.

Argyle is an example of a company that decided to forego cooperation. In the view of Argyle, the benefits gained from cooperation did not justify the sacrifices that were being made. The primary sacrifice was that the CSO was not in a position to purchase all the production from the Argyle Mine. The agreement with Argyle was that the CSO would be obliged to only purchase 85 per cent of production, presumably Argyle was not allowed to dispose of the remaining 15 per cent onto the market. The motivation for this would again be to ensure that diamonds do not enter the market when the market is not ready for them and that this is in the best interests of other producers. Argyle, however, became impatient with cooperation and decided in 1996 that it would not renew its agreement with the CSO and would sell its diamonds directly to the market. There is an argument that this has been to the detriment of the other producers whose production resembles the Argyle production. The prices of these diamonds have fallen but are still
being protected by the central selling organization to some degree. De Beers representatives would argue that Argyle is riding on the coattails of De Beers.

Internal organization of competitors depends on the power of certain competitors to control remaining competitors. Institutional theorists say that the major threat to cooperation is defection and that the key to success is ensuring commitment. This is best achieved when there is one entity amongst the collaborators that is powerful enough to maintain cooperation. This can be compared to a hegemony, where “one state is powerful enough to maintain the essential rules governing interstate relations, and willing to do so”. Cooperation can be ensured by coercive measures or conciliatory measures. In the case of the Israeli sightholders that started speculating in and stockpiling in diamonds the measures taken by De Beers to discipline the sightholders were more coercive-threatening to withhold diamonds, imposing surcharge on diamonds coming through CSO and, ultimately, stripping sightholders of their sights. In the case of Russia, however, the cooperation is more conciliatory, primarily because of the significant power of the Russians at the bargaining table emanating from their large diamond resources.

**Changing the Rules of the Game**

The rules of the game can be changed in a number of ways, including changing the players, the value added by each player, the rules and scope of the game, or the tactics.

**Changing the Players**

Adam Brandenburger and Barry Nalebuff state that successful business strategy is about shaping the game you play in and not just playing the game you find. You can play the game well and still fare very badly. That’s because are playing the wrong game. And when you change the game it must be changed to your advantage. Rhodes, and his successors, believed that De Beers is first and foremost a diamond mining company. This is what the company is best equipped to do. But Rhodes realized right at the outset that it would be pointless for the company to continue producing diamonds if it was not receiving good prices for those diamonds. He realized that the prices of diamonds would
only be maintained if the market was not flooded with diamonds. This would only be achieved if he took control of the production of diamonds and released no more diamonds than the market could bear. By taking control of the production of diamonds and effectively mimimising all the producers in the diamond industry he managed to change the rules of the game.

**Added value**

According to Brandenburger and Nalebluff the rules of the game can also be changed by the amount of value added to the industry. The value added to the industry by a particular player is equal to the size of the pie when that player is in the game less the size of the pie when that player is no longer in the game. Quite clearly, the value added by De Beers to the industry has been immense since it has managed to retain the allure of diamonds as being scarce items in the mind of the consumer. This has kept the prices of diamonds stable and has benefited all the stakeholders in the industry, from producers to sightholders to cutters and polishers to retailers. The value added by a competitor is the key to the power held by that competitor in the game.

The degree of value added is also reflected in De Beers having managed to retain price stability through the following trying periods that threatened the stability of the industry:

- New discoveries in the early 1900’s (South West Africa, Lichtenburg, Premier)
- The dramatic decrease in demand for diamonds experienced during the Great Depression
- Discoveries from the 1950’s onwards (including discoveries in Russia, Australia, Botswana)
- Flooding of the market with diamonds by the Russians in the early 1980’s
- The speculation by sightholders in the 1970’s
- The defection of Argyle in 1996
- Asian crisis and decline in Japanese economy
- New producers – Rio Tinto and BHP
The success with which De Beers has been able to maintain price stability is reflected in the chart indicating the prices of diamonds when compared to other commodities.

**Changing the Rules**

Right at the outset, before Rhodes entered the scene, there were very few rules. Producers were competing with one another regardless of the impact of oversupply on the price of diamonds. Rhodes managed to centralize production and the price of diamonds increased. New producers coming on stream were always approached to become part of the centralized production team. Rules were developed around the relationships amongst the producers. Later, with Sir Ernest Oppenheimer, control was extended from production to distribution. The relationships between the CSO and producers outside of the cartel that were willing to sell their production to the CSO were also subject to rules. Finally, the relationships with sightholders were also subject to informal rules. It can clearly be seen, then, how De Beers has managed to develop the rules of the game over time.

**Changing the Tactics**

The tactics used by Rhodes and his successors are intended to retain the allure of the scarcity of diamonds in the eyes of the consumer. By restricting supply to match demand, diamonds will never be perceived as being in over-abundance, which would negatively impact on the prices that people are prepared to pay for them.

**Changing the Scope**

De Beers changed the scope of the game when it moved from the control of production to extending control down the diamond pipeline. Both measures are directed at regulating supply, but they achieve this in different ways. Control of production enabled De Beers to regulate the quantity of diamonds that would be available for supply to the market. Control of the diamond pipeline enabled De Beers to verify the prevailing consumer trends and supply rough diamonds to the sightholders accordingly.
QUESTION 3

Identify the market signals and trends that were beginning to raise questions about the ongoing effectiveness of the single channel distribution strategy. Analyse their consequences.

The market signals that were beginning to raise questions about the ongoing effectiveness of the single channel distribution strategy can be listed as follows:

- The leaking of Russian diamonds onto the market between the years 1992 and 1997, which was making it difficult for De Beers and other producers to extract value from the industry.
- The increase in worldwide diamond production, particularly since the 1950’s. Although much of this was attributable to the increase in De Beers production there was a clear trend from De Beers producing 90% of the world’s diamonds at the turn of the century to producing 44% in 1999.
- The decrease in the percentage of diamonds worldwide being channeled through the CSO. In the 1950’s approximately 80% of worldwide production was channeled through the CSO but by the late 1990’s this had decreased to approximately 65%.
- The defection of Argyle from the Central Selling Organisation in 1996. According to Ashton representatives De Beers was not in a position to purchase the full quota of production from the Argyle mine and this is one of the factors that prompted the breakaway. It appears that De Beers at that stage was trying to protect the market from the production from Russia. This in turn would have sent out messages to other major world producers that De Beers was not in a position to buy up all production from cooperating producers.
- There had been a steady decrease in demand for diamonds worldwide since 1995, particularly as a result of the Asian crisis and decline in the Japanese economy. It is interesting to note the increase in demand emanating from the USA.
- Production quotas were being imposed on the De Beers mines. In 1998 a 74 % production quota was imposed on the De Beers mines.
- The issue of conflict diamonds arose, resulting in De Beers ceasing the buying of diamonds from Africa.
- New discoveries worldwide and new competitors such as BHP Diamond Inc which has a controlling interest in the Ekati Mine and Rio Tinto which has a controlling interest in Diavik Diamond Mines and is forecast to produce 10 % of world supply by 2003.

**IMPLICATIONS**

**Growing Stockpile**

The factors listed above were contributing to an increase in the diamond stockpile.

In order to retain stability in the marketplace De Beers was being increasingly forced to hold back on sales that were channeled through the CSO (for example in 1997 there was a 28 per cent decrease in the sales of rough diamonds) but was still contracted to buying up diamonds from certain producers even though there was no demand for all of those diamonds. Buying up surplus diamonds was contributing to the size of the stockpile, which at the end of 1998 was worth $4.8 billion.
As can be seen from the graph above this appears to have become more than just a seasonal or cyclical problem and was beginning to appear structural.

**Poor Financial Returns**

The financial burden that was being experienced by De Beers in maintaining a balance between supply and demand was beginning to filter through to the bottom line earnings of De Beers. Return on capital employed had been showing signs of decrease as well as the diamond account margin.
The De Beers share price had been decreasing in real terms (from US$16 in 1989 to US$12 six years later). De Beers shareholder value had accordingly decreased in the 1990’s and this is what prompted and became the overall mission statement for the strategic review – “to increase shareholder value”.

TIMING

It is considered that 80 minutes should be made available to teach De Beers: Stability in the Diamond Industry. This is based on the presumption that both De Beers: Stability in the Diamond Industry and De Beers’ Strategic Transformation will be taught in a single three hour lecture with a 20 minute break.

<table>
<thead>
<tr>
<th>Session Breakdown</th>
<th>Time Allocation</th>
<th>Blackboard Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Q1. 'Factors facilitating dominance'</td>
<td>25 minutes</td>
<td>Fig 1, 2</td>
</tr>
<tr>
<td>Q2. 'Game Theory'</td>
<td>30 minutes</td>
<td>Fig 3-6</td>
</tr>
<tr>
<td>Q3. 'Trends and Market Signals'</td>
<td>25 minutes</td>
<td>Fig 7,8</td>
</tr>
</tbody>
</table>

BLACKBOARD PLAN

Blackboard plans are listed on the following pages.
## QUESTION 1

<table>
<thead>
<tr>
<th>STRUCTURAL FACTORS</th>
<th>SYSTEMIC FACTORS</th>
<th>COOPERATION</th>
<th>CONTROL STRUCTURE- CSO</th>
</tr>
</thead>
<tbody>
<tr>
<td>• High but decreasing Concentration of Production</td>
<td>• Autonomy of competitor</td>
<td>• Producer Sales through the CSO</td>
<td>Regulating Supply</td>
</tr>
<tr>
<td>• High Barriers to Entry</td>
<td>• Shadow of Competitor</td>
<td>• Producers abiding by quota restrictions</td>
<td>• Purchases from major producers</td>
</tr>
<tr>
<td>• Nonsubstitutability of diamonds</td>
<td>• Pockets of Competitor</td>
<td>• Market information from sightholders and retailers</td>
<td>• Purchases on open market</td>
</tr>
<tr>
<td>• Small Fringe</td>
<td>• Capacity to Punish</td>
<td></td>
<td>• Production from De Beers diamond mines</td>
</tr>
<tr>
<td>• Low Bargaining power of Buyers</td>
<td></td>
<td></td>
<td>• Regulating quantity of diamonds released</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Control of diamond pipeline</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Monitoring of market trends</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>• Regulating types of diamonds to be released according to demand</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Stimulating demand for diamonds through advertising</td>
</tr>
</tbody>
</table>

96
**Figure 2**

BUT as control of production by De Beers decreases, importance of cooperation from other producers increases:

1890’s

REGULATION OF SUPPLY THROUGH CONTROL OF PRODUCTION

HIGH

CONTROL OF PRODUCTION

LOW

IMPORTANCE OF COOPERATION

1950’s

1990’s

REGULATION OF SUPPLY THROUGH COOPERATION WITH OTHER PRODUCERS
QUESTION 2

ENLARGING THE PIE: FROM CHAOS TO ORDER TO CONTROL

CECIL JOHN RHODES

1876- CHAOS

In 1876, 3600 claims, 98 syndicates
Diamond prices falling

1889 – ORDER

Consolidation of claims and mines
Centralisation of production
Control of supply
Supply limited to demand

ERNEST OPPENHEIMER

1929- CONTROL

CSO
Arrangements with producers
Buyers of surplus diamonds
Stockpiling
SACRIFICES AND BENEFITS OF COOPERATION

<table>
<thead>
<tr>
<th>Sacrifices</th>
<th>Benefits</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commission on sales paid to CSO thus reduced income</td>
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<td></td>
<td>Publicity for diamond jewellery</td>
</tr>
<tr>
<td></td>
<td>Market research</td>
</tr>
<tr>
<td></td>
<td>Experience in sorting, valuing and marketing of diamonds</td>
</tr>
<tr>
<td></td>
<td>Marketing structure already established</td>
</tr>
</tbody>
</table>
### CHANGING RULES OF THE GAME

**Figure 5**

<table>
<thead>
<tr>
<th>THE PLAYERS</th>
<th>ADDED VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rhodes</td>
<td>SIZE OF PIE WHEN IN GAME - SIZE OF PIE WHEN NOT IN GAME</td>
</tr>
<tr>
<td>• Realised that there were too many players</td>
<td>ADDED VALUE</td>
</tr>
<tr>
<td>• Centralised control of production</td>
<td></td>
</tr>
<tr>
<td>• Minimised players</td>
<td><strong>DE BEERS ADDED VALUE = PRICE STABILITY</strong></td>
</tr>
<tr>
<td>• Became most powerful player because of control over production</td>
<td>NOTWITHSTANDING:</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>• Discoveries in the early 1900’s</td>
</tr>
<tr>
<td></td>
<td>• Decrease in demand during world depression</td>
</tr>
<tr>
<td></td>
<td>• Discoveries from 1950’s onwards</td>
</tr>
<tr>
<td></td>
<td>• Russian diamond leakage</td>
</tr>
<tr>
<td></td>
<td>• Speculation by sightholders</td>
</tr>
<tr>
<td></td>
<td>• Defection of Argyle</td>
</tr>
<tr>
<td></td>
<td>• New producers- BHP and Rio Tinto</td>
</tr>
<tr>
<td></td>
<td>Asian crisis and Japanese economic decline</td>
</tr>
</tbody>
</table>
### CHANGING RULES OF THE GAME (CONTINUED)

<table>
<thead>
<tr>
<th>RULES</th>
<th>SCOPE</th>
<th>TACTICS</th>
</tr>
</thead>
<tbody>
<tr>
<td>1870’s- no rules</td>
<td>1870’s — scope limited to control of production</td>
<td>Tactics of De Beers and CSO are to retain allure of scarcity of diamonds in eyes of consumer</td>
</tr>
<tr>
<td>Rhodes centralizes production</td>
<td>1930’s- scope extended to control of diamond pipeline with taking control of CSO</td>
<td></td>
</tr>
<tr>
<td>With new discoveries in early 1900’s, rules governing relationships between producers</td>
<td>Consumer trends verified and supply regulated accordingly</td>
<td></td>
</tr>
<tr>
<td>Sir Ernest Oppenheimer extends control of supply further down pipeline. Rules develop between CSO and producers</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Rules between CSO and sightholders developed over time</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Question 3 – Figure 7

**MARKET SIGNALS**
- Increasing trend in worldwide production

![Graph showing diamond production trends from 1995 to 1998 for various countries including Russia, Botswana (Jwaneng), Botswana (Orapa), S. Africa (Venetia), Australia (Argle), Canada (Ekati), and others.]

- Decreasing demand since 1995

![Graph showing diamond jewelry sales (US$ Million) for different regions: USA, Japan, Asia Pacific, Europe, Asia Arabia, and Other.]

- Defection of Ashton in 1996
- Decrease in amount of diamonds being channeled through CSO

- Leaking of Russian diamonds onto market

- New powerful competitors (BHP and Rio Tinto)
Diamond Account Margin
INTRODUCTION

The purpose of the case study, 'De Beers' Strategic Transformation', is to demonstrate how De Beers reacted to the trends and market signals referred to at the beginning of the case and decided that the external environment had evolved to such an extent that a change in strategy was required. Subsequent to the strategic review De Beers announced its intention to evolve from being the custodian of the diamond industry to being an effective competitor in a more competitive industry. This would be achieved by moving from being supply driven to demand led. The case study illustrates how De Beers implemented strategic transformation and demonstrates the effect that transformation is having on other players in the industry.

The three questions that could be asked of this case study are:

Q1. Speculate as to the consequences for De Beers if it decided to continue focussing purely on supply-side measures to regulate the environment, notwithstanding the trends and market signals identified at the outset of the case?

Q2. Discuss the internal transformation of De Beers with reference to John P. Kotter’s transformation model and establish what was done well and what was not.

Q3. What is the potential effect of De Beers' strategic transformation on the other major players in the diamond industry?

The first question will open the students up to the key business drivers at the end of the 20th century and a review of the strategic options available to De Beers. Conclusions may also be drawn from the negative signals the markets were sending out on De Beers' performance and students will have to decide whether they believe the trends were
cyclical or structural. Students can speculate as to the position of De Beers on the sigmoid curve at the time that the review was launched.

The second question will allow the students to discuss the internal and procedural aspects of the strategic transformation.

The final question will require that the students examine the implications of De Beers’ transformation for other players in the industry. This will apply to players both upstream and downstream of De Beers in the diamond pipeline. The review will impact primarily on the business strategies of sightholders as well as upon emerging competitors, who may become the subject of takeover bids from De Beers as the company seeks to gain control over production.

**READING LIST**

The following is a list of readings that could be useful to the student as background research for the questions on organisational transformation and change:

QUESTION ONE

Q1. Speculate as to the consequences for De Beers if it decided to continue pursuing the single channel distribution strategy by ignoring the emerging trends and market signals?

Status Quo

This question can be answered by discussing De Beers’ position on the sigmoid curve. A decision needs to be made about whether the predicament facing De Beers was a cyclical or structural one. If it was cyclical then there is no reason to conclude that De Beers was on the decline slope. If the problems were structural, then the conclusion can be drawn that De Beers was in decline when the review was initiated and that the review was justified.

De Beers' market share was falling. The company’s ability to effectively manage price appeared to be decreasing (witness the flattening out of diamond prices in the 1990’s) and it was certainly getting more expensive (witness the increasing stockpile and poor financial indicators) Diamonds had been under performing as a luxury during the 1990’s, particularly since demand for diamonds had been steadily decreasing from the mid to late nineties. De Beers had catered for the decrease in demand and loss of market share by placing production quotas on operations, i.e., slowing mine development and production rates, and by growing the diamond stockpiles. In both cases problems arose since De Beers was in effect subsidising other producers in the industry by foregoing revenues or increasing expenditure to maintain price stability that other producers were benefiting from.

The trends and market signals from other competitors suggested that De Beers was on a steady decline. They can be listed as follows:
**TRENDS**  
- Decreasing control over production  
- Decreasing supply of diamonds being channelled through CSO  
- Decreasing demand  
- Increasing stockpile  
- Poor financial returns  
- Flattening of diamond prices in the 1990’s  

**MARKET SIGNALS**  
- Argyle defection in 1996  
- Russian leakage of diamonds onto market  
- New competitors and new discoveries  

Most of the trends appeared to be of a long term nature. The stockpile had been on the increase since the 1970’s, financial returns in the 1990’s had been poor, control over production had been steadily decreasing since the turn of the nineteenth century, and less and less diamonds had been flowing through the CSO since the 1950’s.

There is no reason to believe that these factors would improve overnight. They are indicative of a continuous trend and not a cycle. What had also been disconcerting was the defection of Argyle in 1996 since it appeared that the depressed market environment and leakage of Russian diamonds was directly responsible for De Beers not being able to purchase all of the Argyle production. This caused the defection and could be seen as an indication that other producers saw De Beers as losing its grip over the market.

In the circumstances De Beers was going through huge expense to retain stability in the industry but was losing control anyway. On top of this De Beers had been co-subsidising the other producers, not only in terms of maintaining price stability but also through the blanket marketing of diamonds. It is suggested therefore that De Beers had already started to decline before implementing the strategic review and that the review was a reactive rather than a proactive measure. De Beers accordingly occupied the following position on the sigmoid curve before the review was initiated.
Geoffrey Lewis states that over time organisations tend to drift out of line with their environment. Transformational change is needed in circumstances where misalignment threatens the livelihood of an organisation. If the organisation is to survive, the routine behaviour must be replaced by radical new behaviours that are perhaps unfamiliar. In many cases these new behaviours will be foreign and strange to those within an organisation that are used to the ‘old way of doing things’. It is submitted that this is precisely what happened to De Beers. De Beers have over time managed to cope with market instability by supply-side measures but the evolution of the market had resulted in these measures becoming very expensive and less effective.

It could in fact be argued that by the time Cecil John Rhodes had centralised production the industry, and hence the organisation, was also in decline already since the prices for diamonds had already started plummeting and Rhodes’ moves to gain control over
production were in reaction to the crisis which had struck the industry. Similarly, Sir Ernest Oppenheimer’s moves to extend control further down the diamond pipeline came in reaction to the crisis that the company and the industry were in after the discovery of the Lichtenburg and Namaqualand alluvial deposits (see figure in Blackboard Plan).

If demand for diamonds escalated, however, this could turn the situation around since the stockpile would be decreased and the mines could produce knowing that their production would be purchased. That is why De Beers have turned their attention from managing the supply of diamonds to stimulating demand for diamonds. Managing supply was becoming so expensive that it was impacting upon shareholder value, and the ongoing effectiveness of managing supply was even questionable. Although De Beers will move away from being supply driven to demand led, the existing business model of regulating supply will still play a pivotal role but there will be a move towards controlling supply by gaining control over production, which is more cost effective, and there will be a drive away from open market purchases. Andrew Jackson, a diamond analyst with Deutsche Bank Securities in Johannesburg stated in November 2000 that "Even under the old system, which effectively we are still operating under, the company is looking for a new start." What De Beers are trying to do is not necessarily to limit the stock build up from a supply side but limit the stock build up by stimulating the demand side. They now see it more as a demand side driven argument.

The benefits of the additional De Beers marketing spend to stimulate demand will not be diluted amongst all the other producers since it will raise awareness of the De Beers brand. Although the diamond industry as a whole will benefit because competing brands stimulate demand, the money spent by De Beers on marketing diamonds will increase awareness of the De Beers brand and therefore the benefits will accrue mainly to De Beers.
**QUESTION TWO**

Q2. Discuss the internal transformation of De Beers with reference to John P. Kotter’s transformation model and establish what was done well and what could have been done better.

<table>
<thead>
<tr>
<th>Kotter's Eight Steps</th>
<th>De Beers’ Eight Steps</th>
<th>Marks out of five</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>TRANSFORMING YOUR ORGANISATION</strong></td>
<td><strong>TRANSFORMING THE ORGANISATION</strong></td>
<td>3</td>
</tr>
<tr>
<td>1. ESTABLISH A SENSE OF URGENCY - examining markets and competitive realities, identify and discuss crises or major opportunities.</td>
<td>1. ESTABLISHING A SENSE OF URGENCY - The Operations Manager had been asking questions to senior De Beers management (Executive Chairman and Managing Director), towards the end of 1998 about the vision for De Beers and the diamond industry. He needed to have a very clear view from Executive Management as to the future De Beers, in order for him to be able to manage the mining operations effectively. Thus, although no sense of urgency had been established, there was a sense of anxiety about the future direction of the company. This anxiety evolved into urgency when the realities of decreasing shareholder value became apparent.</td>
<td></td>
</tr>
<tr>
<td>ERRORS WHEN MANAGING CHANGE - Allowing too much complacency. Comments emanating from the company suggest that there was a feeling of anxiety from not having a full understanding of the future of the diamond industry. This anxiety led to the Oxford seminars and it is only when the problems surrounding shareholder value were staring the executives in the face that the anxiety was converted to urgency.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. FORMING A POWERFUL GUIDING COALITION - assembling a group with enough power to lead the change effort and encourage the group to work together as a team.</td>
<td>2. FORMING A POWERFUL GUIDING COALITION - The Strategic Task Team (STT) was formed for the review process and was made up of all members of the Executive Committees in De Beers. There were traditionally two Executive committees in De Beers, one in Johannesburg (Operations) and one in London (Marketing &amp; Sales), both of which are</td>
<td>4.5</td>
</tr>
<tr>
<td>ERRORS WHEN MANAGING CHANGE - Failing to create a powerful guiding coalition. In De</td>
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</tr>
</tbody>
</table>
Beers’ case the task team was extremely powerful. (Marketing & Sales), both of which are chaired by the Managing Director. The STT also included a number of very senior and influential "change agents" in the company. Today the STT remains as the guiding coalition of strategic change in De Beers and meets ten times a year at locations varying between London, Johannesburg, Lucerne, Kimberley.

3. CREATING A VISION - creating a vision to help direct the change effort and developing strategies for achieving that vision.

ERRORS WHEN MANAGING CHANGE - Lack of understanding in the power of Vision. De Beers’ clear and concise statement was extremely focused in creating the vision to ensure all stakeholders understood the future direction of the company and hence the industry.

3. CREATING A VISION – The realisation that the De Beers stock was value destroying for its shareholders and that the diamond stockpile was not regarded as an asset but as a liability was the driving force giving rise to the new vision. Out of the Oxford seminars came the strategic review mission statement "THE NEED TO FOCUS ON CREATING AND ENHANCING STAKEHOLDER VALUE AND ESPECIALLY SHAREHOLDER VALUE." This simple statement became the guiding light and driving force for all subsequent decisions.

4. COMMUNICATING THE VISION - using every vehicle possible to communicate the new vision and strategies, teaching new behaviours by example of the guiding coalition.

ERRORS WHEN MANAGING CHANGE - Under communicating the Vision by a factor of Ten. Comments from within De Beers claim that the communication in terms of awareness was good, but very poor in terms of understanding. This poor understanding resulted in a lack of commitment from middle managers.

4. COMMUNICATING THE VISION - Communication was via in house publications, management committee meetings and a general downward cascade of information. Other channels of communication used were emails, the intranet, topic specific conferences (Debcon and Metcon), and the use of change agents within divisions. There were splashes of communication offering a more in depth look at one of the major initiatives that were being undertaken as a result of the review. It was felt that the use of emails to communicate information about the changing situation was effective and
management. strategic review was very effective as it had a more personal touch. However, a survey had been carried out to determine how well the review had been communicated and the general response was that it had not been well communicated.

| 5. **EMPOWERING OTHERS TO ACT ON THE VISION** - getting rid of obstacles to change, changing systems or structures that seriously undermine the vision, encouraging risk taking and nontraditional ideas, activities and actions. |
| **ERRORS WHEN MANAGING CHANGE** - Permitting obstacles to block the view. Generally, divisions attempted to meet objects emanating from the strategic review, which were made relevant for their particular business unit. The Director at the head of the business unit was accountable for removing any "road blocks" or obstacles that appeared. |
| 6. **PLANNING FOR AND CREATING SHORT TERM WINS** - planning for visible performance improvements, creating those improvements, recognising and rewarding employees involved in the improvement. |
| **ERRORS WHEN MANAGING CHANGE** - Failing to create Short Term Wins. It would appear that De Beers have successfully set out objectives for the various business units that are achievable in the short term. |

| 6. **PLANNING FOR & CREATING SHORT TERM WINS** – De Beers have documented a wide range of goals from specific project performance targets to divisional improvement goals set annual. The balanced scorecard model has been implemented at a business unit level in order to bring De Beers new strategy and new performance measures together as one. Wider, far reaching "Bhags" have been set in cement by the Managing and Divisional Directors. These stretch goals have a 3 to 4 year window. |
7. CONSOLIDATING IMPROVEMENTS AND PRODUCING STILL MORE CHANGE - using increased credibility to change systems, structures and policies that don't fit the vision, reinvigorating the process with new projects, themes and change agents.

**ERRORS WHEN MANAGING CHANGE - Declaring Victory too soon.** By August 2000 the first promising results started to filter through. De Beers however are well aware that the tripling in first half earnings was not solely the fruits from the 3 major initiatives undertaken by De Beers in 1999 & 2000. The excellent results they acknowledged were on the back of very strong global demand as the 20th century closed.

8. INSTITUTIONALISING NEW APPROACHES - articulating the connections between the new behaviour and corporate success, develop the means to ensure leadership development and succession.

**ERRORS WHEN MANAGING CHANGE - Neglecting to Anchor changes firmly into the Corporate Culture.** The changes will only be firmly anchored into the corporate culture if the company is able to retain the dynamic young management team currently in the company.

8. INSTITUTIONALISING NEW APPROACHES – Although it is still early days it would appear that several dynamic change agents are being prepared for senior leadership positions within the company. These change agents are advocates of the links between new behaviour and openness to change
QUESTION THREE

Q3. What is the potential effect of De Beers' strategic transformation on the other major players in the diamond industry?

Effect on the Diamond Pipeline
De Beers is so dominant that the company cannot divorce itself from the market. When De Beers' says "we are no longer going to be custodian", most industry commentators would counter that De Beers will continue to have a degree of custodianship over the diamond industry for many years to come.

Historically, De Beers have been able to manipulate and manage price through the limitation of supply, be it production quotas or stockpiling of diamonds, and have also stimulated demand through their marketing efforts. De Beers have been active on both sides of the supply and demand equation but have focussed on maintaining price stability through supply-side measures. As their market share fell, the cost of maintaining price has increased and the effectiveness of that effort has decreased. When De Beers cut back on supply other producers stepped into the breach to fill the gap. De Beers was effectively transferring the gearing of the entire industry through their income statement and on to their balance sheet. The other producers were getting a free ride. The decreasing effectiveness of the traditional business model, coupled with the expense of implementing that model (stockpiling and subsidising other producers), was beginning to raise some serious questions about the sustainability of the model. Hence the strategic review.

However, pricing is still central to De Beers’ business model and one cannot conclude that all supply-side measures will be eliminated. When new producers come on stream efforts will be made to channel that production through the DTC. First prize will be to actually gain control over production as this is a less expensive way of regulating supply but if this is not possible it will still be preferable for the production to be channelled
through the DTC for the sake of price stability. But the focus has changed from the manipulation of supply to the stimulation of demand. If demand is strong enough then there is no need to regulate supply.

**Downstream**

In the move away from being supply driven and towards being demand led De Beers seeks to establish itself as the Supplier of Choice in a more competitive diamond market. The Supplier of Choice programme has huge implications for the sightholders as De Beers will favour the larger, vertically integrated and well-capitalised sightholders. This is going to reduce the number of sightholders and force vertical integration in the diamond trade, and probably force consolidation with the marginal players squeezed out. The result will be fewer but larger commercial players. Sightholders will be expected to lodge business plans that indicate their affiliation towards marketing and distribution, as well as open their books to the DTC. This does not bode well for sightholders who do no more than buy and sell stones. The DTC will offer the favoured sightholders an extensive package of value-added support services to assist them in developing an advertising and promotion strategies. The support service will equip them to drive consumer demand, includes training, marketing and business planning solutions, market research and information, and a pipeline wide extranet.

Furthermore, De Beers is now encouraging the sightholders to develop their own brands and to market their products. Previously, where sightholders had a narrow margin business they could not afford marketing, but now they cannot afford not to market, and spend on advertising and promotion of their products. The objective here is to stimulate brand competition because that will stimulate global demand for diamonds. This will certainly impact on sightholders who will all want to make sure that they are invited to future sights and will want to impress De Beers with their branding efforts.

**Upstream**

To a degree there will be increased marketing spend and a proliferation of brands, which is positive for industry growth. However, De Beers will try to get extra mileage out of the
De Beers brand. De Beers are developing the "Forevermark", which is really the equivalent of the "Woolmark", a guarantee of prominent quality and assurance of conflict free and natural diamonds.

Market share is important to what De Beers are trying to do in terms of supplying their major sightholders needs. They want the major sightholders to be 100% reliant on DTC. In order to do that De Beers need to be able to supply the full spectrum of product. This means that they are still going to need products from outside producers. De Beers went to extraordinary lengths to secure Ashton, the owners of the Argyle Mine in Western Australia. This acquisition was considered core to the new strategy as the Argyle stones fill the lower reaches of the market. This also ties in with De Beers’ branding initiatives. De Beers diamonds are going to be a high end branded product, and the more rough De Beers have access to, the more they can pick and choose the goods necessary for a premium pricing strategy.

The preference in securing diamond supplies that cover a broad spectrum of diamonds will be to gain control over the production of competing mines, as opposed to merely having those diamonds channelled through the DTC. Gaining control of production will result in a cost saving for the company when compared to tying up production through contracts between the DTC and other producers.

De Beers will no longer be buying diamonds on the open market. The conflict diamonds issue that surfaced in 1999 has pushed De Beers out of the open market. In previous downturns and even up until November 1998 De Beers actively purchased diamonds on the streets of Antwerp and Tel Aviv, mopping up excess production in support of price. Obviously in terms of the conflict diamond landscape, that is now out of the question, and has precluded the De Beers from these activities in the future.
The Brand
A branded De Beers retail outlet is a strong possibility in the medium to long term. De Beers however, still have an outstanding indictment in the United States. They are actively speaking to the Department of Justice in terms of resolving those issues. Even if they resolve that outstanding indictment, they would still be a company under suspicion under US law, because they have more than 30% of a particular market, but that does not mean that they cannot operate. However, using a dominant position in one market to influence one’s position in another market i.e. rough to retail, would raise the ire of both the United States Department of Justice and the European Union’s Competition Commission. What some observers envisage is a joint venture with a luxury goods company, whereby the luxury goods company would be the majority shareholder in an independently owned and managed company that has taken ownership of the De Beers brand name. That company would have access to US market, the largest consumer market in the world with 44% of all retail sales in 1998.

TIMING

It is considered that 80 minutes should be made available to teach case study B. This is based on the presumption that both De Beers: Stability in the Diamond Industry and De Beers’ Strategic Transformation will be taught in a single three hour lecture.

<table>
<thead>
<tr>
<th>Session Breakdown</th>
<th>Allocation</th>
<th>Blackboard Plan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Introduction</td>
<td>10 mins</td>
<td>Fig 7</td>
</tr>
<tr>
<td>Q1 'Maintaining the status quo'</td>
<td>25 mins</td>
<td>Fig 1-2</td>
</tr>
<tr>
<td>Q2 'Transformation of De Beers'</td>
<td>20 mins</td>
<td>Table 1 &amp; 2, Fig 8-11</td>
</tr>
<tr>
<td>Q3. 'The effect on the other players'</td>
<td>25 mins</td>
<td>Fig 3 &amp; 12</td>
</tr>
</tbody>
</table>
Figure 1: Internal Vs External Business Drivers, Yr2000

- Creating shareholder value
- Stockpile reduction
- Sales growth
- Supplier of choice
- Competition
- Exploiting the brand

- Match supply and demand
- Low cost production
- Customer focus
- Collaboration
- Performance culture
- Better quality info

De Beers Mining Operations
Figure 2: Trends and Solution

<table>
<thead>
<tr>
<th>TRENDS</th>
<th>MARKET SIGNALS</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Decreasing control over production</td>
<td>• Argyle defection in 1996</td>
</tr>
<tr>
<td>• Decreasing supply of diamonds being channelled through CSO</td>
<td>• Russian leakage of diamonds onto market</td>
</tr>
<tr>
<td>• Decreasing demand</td>
<td>New competitors and new discoveries</td>
</tr>
<tr>
<td>• Increasing stockpile</td>
<td></td>
</tr>
<tr>
<td>• Poor financial returns</td>
<td></td>
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<tr>
<td>• Flattening of diamond prices in the 1990’s</td>
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</table>

**SOLUTION: STIMULATE DEMAND**

SUPPLY DRIVEN ➔ DEMAND LED
Figure 3: De Beers Strategic Transformation Model

1. **STRATEGIC PLAN**
   - Supplier of Choice
   - As Is Plus
   - Branding Opportunities

2. **MARKET OPPORTUNITIES**

3. **STRENGTHS OF DE BEERS**

4. **INDUSTRY IMPLICATION**

5. **ORGANISATIONAL IMPLICATIONS**

6. **STRATEGIC TRANSFORMATION**

7. **MARKET OPPORTUNITIES**

8. **Aging = f(mental age, relative market share, functionality of organisation)**

9. **Figure 3: Adizes Model - De Beers, Yr1999**

10. **P – Production**
    **A – Administration**
    **E – Entrepreneurship**
    **I – Integration**

11. **Prime**
    **Adolescence**
    **Go-Go**
    **Infancy**
    **Courtship**

12. **Maturity**
    **Aristocracy**
    **Early Bureaucracy**
    **Bureaucracy**
    **Death**

13. **De Beers**
Figure 4: The Metamorphosis of a Butterfly: Transformation

![Figure 4 Diagram](image)

Figure 5: Diagrammatic Interpretation of the Definition of a ‘Transformation’

![Figure 5 Diagram](image)
Figure 7: De Beers' Strategic Inflection Points

1890 - Rhodes buys up diamond mines
1932 - Ernest Oppenheimer
1999 - Strategic Review Process
2000 - Strategic Transformation starts to bear fruit

Figure 8: Goals - Operations

- 50% of world production by value, produced by De Beers & Partners by 2004
- Growth through exploration, expansion, acquisition & commissioning
- Investing in our own people
- Delivering Production to Plan
- Improving the NPV of all operations
Figure 9: Goals - Producer Relationships

Growing the value of our rough diamond business by:

- Managing successful Partnerships
- Buyer of Choice
- Advanced sorting & valuing skills
- Pipeline Reduction & ISM

Figure 10: Goals - Marketing & Sales

Supplier of Choice: Build the proprietary diamond distribution channel

- Drive demand
- Creating Competitive Advantage
- Answering Consumer Needs
- Add Value
### TABLE 2: KOTTER'S EIGHT STEPS

<table>
<thead>
<tr>
<th>STEP</th>
<th>DE BEERS</th>
</tr>
</thead>
<tbody>
<tr>
<td>SENSE OF URGENCY</td>
<td>✔</td>
</tr>
<tr>
<td>POWERFUL GUIDING COALITION</td>
<td>✔</td>
</tr>
<tr>
<td>VISION</td>
<td>✔</td>
</tr>
<tr>
<td>COMMUNICATION OF VISION</td>
<td>✗</td>
</tr>
<tr>
<td>EMPOWERMENT</td>
<td>✗</td>
</tr>
<tr>
<td>SHORT TERM WINS</td>
<td>✔</td>
</tr>
<tr>
<td>CONSOLIDATING IMPROVEMENTS</td>
<td>✔</td>
</tr>
<tr>
<td>INSTITUTIONALISING</td>
<td>✔</td>
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</tbody>
</table>

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**Figure 11: Goals: De Beers – Company wide ‘BEHAG’**

- **Market valuation of De Beers’ to reach US$10 billion by 2004**
- **Our greatest asset is people**
- **Developing a performance based culture**
- **Performance based remuneration**
- **Assigning KPI’s**
Figure 12: EFFECT ON DIAMOND PIPELINE

- De Beers and partner mines
- Cooperative producers
- Outside Producers
- Takeovers
- Production
- DE BEERS/ DTC SUPPLIER OF CHOICE
- SMALLER SIGHTS OUT
- SIGHTHOLDERS
- DTC DRIVING DEMAND AND BRAND AWARENESS THROUGH SIGHTHOLDERS
- RETAIL
- Well capitalised
- Business Plans
- Marketing and Distribution
- Vertically integrated
- Brand Awareness
- Production
- Takeovers
THEORETICAL NOTE - DE BEERS: STABILITY IN THE DIAMOND INDUSTRY

"Philosophers only interpret the world. The point, however, is to change it"

Karl Marx

THEORY REGARDING CARTELS

Economists have identified five structural factors that are most important in determining the formation of producer cartels. They can be listed as follows:

<table>
<thead>
<tr>
<th>STRUCTURAL FACTOR</th>
<th>EFFECT</th>
</tr>
</thead>
<tbody>
<tr>
<td>High concentration of production</td>
<td>The fewer producers in the marketplace the easier it is for them to come together with a view to cooperating.</td>
</tr>
<tr>
<td>High barriers to entry</td>
<td>If it is easy for outsiders to gain entry into the industry there is a significant threat of production entering the market that threatens price stability.</td>
</tr>
<tr>
<td>Small fringe</td>
<td>These are producers that are not regarded as having sufficient power to become a member of the cooperative alliance. The fewer of them the less chance there is of them having a collective impact on price stability.</td>
</tr>
<tr>
<td>Nonsubstitutability</td>
<td>If consumers are easily able to find substitutes as prices rise it will be more difficult for producers of the substituted goods to effectively manage the market.</td>
</tr>
<tr>
<td>Nondifferentiation</td>
<td>Producers cannot engage in nonprice</td>
</tr>
</tbody>
</table>
Although these structural factors are important they do not go all the way in explaining the circumstances in which cartels operate. However, Professor Debora Spar points out the importance of cooperation amongst participating producers.

Essentially, there are two dominant theories regarding cooperation. The realist theory emphasizes the role played by the hegemon, or most powerful producer, in ensuring that producers cooperate. This can be imposed by conciliatory or by coercive measures. Then, there is the institutional theory of cooperation, which stresses the importance of a system of rules to ensure cooperation. Those rules should ensure that future cooperation is guaranteed and defection is punished. Future cooperation will depend upon commitments. In an attempt to get a better understanding Professor Spar refers to four internal characteristics regarding the internal organization of institutions that will facilitate cooperation. They are as follows:

**The Autonomy of the Competitor**

The ability of producers to effectively participate in cooperative arrangements will depend upon the ability of those producers to deliver on their undertakings and that will in turn depend on the ability of the organization to control the different factions that exist within it. Tight organization will result in delivery upon commitments.

**The Shadow of the Competitor**

Cooperation is more likely to occur when the prospects of cooperation are long term. If the long term benefits are negligible competitors will be tempted to forsake long term cooperation in favour of short term gains.
The Pockets of the Competitor

When the market is depressed it is important that all competitors are willing and able to resist short term gains which will impose significant costs and compromise other industry participants. This requires that the competitors have sufficient financial reserves to see them through the difficult times.

The Capacity to Punish

There is always a risk of competitors defecting. That is why it is important for participating competitors to raise the costs of defection. If breaking the rules is tolerated, this will become more likely. It is important for at least one competitor to take the responsibility of punishing defectors.

The case study on De Beers has demonstrated the applicability of the aforegoing factors to De Beers. They can be summarized as follows:

<table>
<thead>
<tr>
<th>Autonomy of the Competitor</th>
<th>De Beers has on several occasions demonstrated its commitment and ability to deliver on undertakings. One of the earliest examples relates to the Great Depression and De Beers acquiring diamonds from African countries in terms of its undertaking, despite there having been no market for those diamonds. Witness also the purchasing of surplus Russian produce in the 1980’s, at the request of other industry stakeholders such as producers and jewellery manufacturers.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shadow of Competitor</td>
<td>The rapid economic growth experienced by Botswana is illustrative of the benefits of a long term relationship with De Beers and cooperating to retain the price stability in the diamond industry.</td>
</tr>
<tr>
<td>Pockets of Competitor</td>
<td>De Beers has displayed its huge financial strength on several occasions by intervening to protect the market. An example is buying up excess production when the</td>
</tr>
</tbody>
</table>
Russians flooded the market with diamonds in the 1980’s.

| Capacity to Punish | The capacity to punish was demonstrated by De Beers when it imposed an unprecedented surcharge of 40 % on all diamonds that pass through the CSO- a step taken to prevent speculation in diamonds. The punishment was extended by failing to invite certain sightholders back to future sights. |

**GAME THEORY**

Game theory is a useful way of understanding the nature of the relationships among players in a business environment. In any situation there is potential for conflict and potential for co-operation. McMillan likens the situation to dividing a pie. All of the players want the pie to be as large as possible but when it comes to dividing the pie they all want their slice to be as large as possible. But in striving to maximize individual slices of the pie, players might be diminishing the size of the entire pie. So there is a tension between seeking a large slice and a large total pie. All diamond producers are the players in this instance. In the beginning Rhodes noticed how all the producers kept producing without regard to their output and simply to achieve maximum profit. In 1876 there were 3600 claims in the hands of 98 syndicates. He noticed how this was adversely impacting on the price of diamonds as a result of over-supply. He realized that if this continued it would result in a lose-lose situation for all competitors. The slice of the pie would be diminished because the prices of diamonds would fall as a result of oversupply. Thus he saw that individuals striving to maximize individual share of the pie would diminish the size of the entire pie.

Rhodes managed to enlarge the pie by gaining control over production and accordingly regulating the supply of diamonds to the marketplace. This resulted in an increase and maintenance in the price of diamonds and, accordingly, an
increase in the size of the pie. This increased the attractiveness of the industry and existing and potential diamond producers could benefit from the steps taken by Rhodes to maintain the prices of diamonds.

Game theory is applicable to all situations where the fortunes of the participants are interdependent. Brandenburger and Nalebuff encourage businesses to consider win-win alternatives as well as the typical win-win alternatives. This requires both competitive as well as cooperative thinking- hence the term coopetition. The authors suggest that successful business strategy is about actively shaping the game you play and not just playing the game you find. According to game theory there are five elements of a game that can be changed:

- **Players**: the customers, suppliers, substitutors and complementors;
- **Added values**: what each player brings to the game;
- **Rules**: the structure of the game is shaped by rules;
- **Tactics**: moves used to shape the way players perceive the game;
- **Scope**: describes the boundaries of the game.

The applicability of each of these to De Beers and the evolving history of De Beers can be analysed in turn:

<table>
<thead>
<tr>
<th>PLAYERS</th>
<th>Rhodes realized right at the outset that it would be pointless for De Beers to continue producing diamonds if it was not receiving good prices for those diamonds. Price stability would only be achieved if Rhodes took control of the production of diamonds and released no more diamonds than the market could bear. By taking control of the production of diamonds and effectively mimimising all the producers in the diamond industry he managed to change the rules of the game.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Added values</td>
<td>The value added to the industry by a particular player is equal to the size of the pie when that player is in the game less the size of the pie when that player is no longer in the game. Quite clearly,</td>
</tr>
</tbody>
</table>
the value added by De Beers to the industry has been immense since it has managed to retain the allure of diamonds as being scarce items in the mind of the consumer. This has kept the prices of diamonds stable and has benefited all the stakeholders in the industry, from producers to sightholders to cutters and polishers to retailers. The value added by a competitor is the key to the power held by that competitor in the game.

| Rules | Right at the outset, before Rhodes entered the scene, there were very few rules. Producers were competing with one another regardless of the impact of oversupply on the price of diamonds. Rhodes managed to centralize production and the price of diamonds increased. New producers coming on stream were always approached to become part of the centralized production team. Rules were developed around the relationships amongst the producers. Later, with Sir Ernest Oppenheimer, control was extended from production to distribution. The relationships between the CSO and producers outside of the cartel that were willing to sell their production to the CSO were also subject to rules. Finally, the relationships with sightholders were also subject to informal rules. It can clearly be seen, then, how De Beers has managed to develop the rules of the game over time. |
| Tactics | The tactics used by Rhodes and his successors are intended to retain the allure of the scarcity of diamonds in the eyes of the consumer. By restricting supply to match demand, diamonds will never be perceived as being in over-abundance, which would negatively impact on the prices that people are prepared to pay for them |
| Scope | De Beers changed the scope of the game when it moved from the control of production to extending control down the diamond pipeline. Both measures are directed at regulating supply, but they achieve this in different ways. Control of production enabled De |
Beers to regulate the quantity of diamonds that would be available for supply to the market. Control of the diamond pipeline enabled De Beers to verify the prevailing consumer trends and supply rough diamonds to the sightholders accordingly.

**MARKET SIGNALS**

Porter tells us that one of the central characteristics of competition is that firms are mutually dependant and feel the effect of competitors’ moves and are prone to react to them. A firm can pursue the interests of the industry as a whole and thereby not incite reaction, or it can act in the interests of the firm alone and escalate industry competition, or perhaps even endanger the existence of the industry. A firm can forsake a degree of profitability for the benefit of the industry as a whole, or it can maximize profits at the risk of destabilizing the industry and invoking a response from competitors.

A market signal is any move by an industry participant that indicates its intention, goals or internal situation. One must bear in mind, however, that not all signals are necessarily an honest reflection of the motives of a competitor and might by intentionally misleading. Some market signals might be bluffs, therefore, but others might be an earnest commitment to a course of action. It is up to the competitor analyzing the signals to make a call in this regard.

There are several types of market signals that emanate from competitors including prior announcements of moves, announcements of results or actions after the fact, public discussions of the industry by competitors and competitors’ tactics relative to what they could have done. The types of market signals that are most applicable to Case A are prior announcements of moves and competitors’ tactics relative to what they could have done.

Ashton, before it announced its intention to depart from the CSO made certain announcements indicating that it was dissatisfied with the CSO only purchasing 85 % of its production as well as with the manner in which the price book was
aligned. Both had impacted negatively on Ashton. It would appear that the CSO did not react to these moves by realigning the price book again or undertaking to purchase all Argyle production. This would suggest that the CSO regarded the prior announcements as a bluff, or did not want to set a bad precedent or thought that Ashton would not survive if left to the vagaries of the market.

The unloading of Russian diamonds onto the market in the 1980’s was clearly a hostile signal from the Russian authorities. The CSO had always had some difficulty in persuading the Russians to sell all their production through the CSO and had never succeeded entirely. The option was, however, available to The Russians to sell its production to he CSO and cooperate with De Beers in maintaining market stability. It is clearly in the interests of the Russians that the diamond market remains stable. When it unloaded diamonds onto the market this was a signal to De Beers. It would appear that the intention was simply to indicate to De Beers the strength of the Russian hand. There was a significant supply of diamonds emanating from Russia and if it wanted to it could significant instability in the market. When it did release the diamonds onto the market the result was in fact damaging and De Beers went to huge expense to restore stability. However, after the move De Beers had agreed to purchase more diamonds from the Russians and also to increase the price that it paid for those diamonds. It would appear that the risky Russian tactics had paid off.
THEORETICAL NOTE - DE BEERS' STRATEGIC REVIEW

"Don't be happy with where you are now, look to continually transform yourself"

Professor Gary J. Stockport

STRATEGIC TRANSFORMATION

Introduction
Senior management today are being challenged to respond to an ever changing environment that is becoming increasingly more competitive. In order to create and enhance competitive advantage, companies are considering radical manoeuvres in the way they operate. This strategic transformation will require measuring a company's performance together with its strategy against the evolving business landscape. This theoretical note will cover some of the contemporary models that have been published in the last decade to draw comparisons and will examine the potential low buy in of middle managers during strategic transformation.

Organisational strategic transformation is said to be as inevitable as birth, death and taxes.¹ Stockport tells us that "Business history has become a graveyard of former business success stories that have failed", implying that organisations need to find ways to continual adapt to the current business environment to ensure a sustainable long-term future.

Hamel and Prahalad³ noted in 1994, that in a twenty year window from 1970 to 1990 around two thirds of the Fortune 100 largest companies in the world did not exist by the end of the period, or had been transformed into something completely new. This metamorphosis, or strategic transformation, often meant that the company radically altered its business model to serve new markets, creating new services and products and acquiring new customers.
Geoffrey Lewis\textsuperscript{iv} states that over time organisations tend to drift out of line with their environment. Transformational change is needed in circumstances where misalignment threatens the livelihood of an organisation. If the organisation is to survive, the routine behaviour must be replaced by radical new behaviours that are perhaps unfamiliar. In many cases these new behaviours will be foreign and strange to those within an organisation that are used to the ‘old way of doing things’.

This is the difference between continuous improvement, which results in incremental changes during a period of stability and is aimed at continuing to improve the fit among the stakeholders in an organisation, and transformation. Transformational change in corporate strategy occurs when the demands of a radically changing environment require equally radical changes in organisations. According to Palmer and Hardy these changes are a effected by time - whether they are implemented in anticipation of the need to change or whether they are carried out in hindsight as management is forced to respond to the pressures for change. They categorise transformation/change into four types:

1. **Tuning** - occurs when an organisation makes incremental changes in anticipation of future events
2. **Adaptation** - occurs when an organisation makes incremental changes in reaction to changes in the external environment
3. **Reorientation** - occurs when an organisation makes radical or transformational change in anticipation of future environmental changes
4. **Recreation** - occurs when an organisation makes radical changes in its core values reacting to environmental factors (De Beers Case)

Strategic transformation puts a company on the road to a new ‘frame of reference’. Lewis believes that this transformational change in organisations involves three distinct overlapping phases:
1. **The breakdown of the old frame of reference.** The organisation is forced to break from its status quo and challenge the routine behaviours and norms.

2. **Transformation.** At this phase a new frame of reference starts to evolve.

3. **Propagation of a new frame of reference.** In this phase the process of strategic change gradually becomes infused throughout the organisation. In the case of De Beers, the change process involved to fully encapsulate the new strategy of ‘Supplier of choice’ will take years to unravel. Some editing and refining of the new frame of reference will become clear to all stakeholders in the industry as the implications of this new direction are tested.

**Contemporary Transformation Models**

This 3 step model of Geoffrey Lewis, like many transformation/change models, runs almost identical to the model developed in 1947 by Kurt Lewin. Lewins' model is an analogue, which portrays the organisation as an 'ice cube':

- **Initial stage** - entails "unfreezing" the way the organisation currently operates
- **Second stage** - entails "changing" the organisation in a specific direction
- **Final stage** - entails "refreezing" these changes into the mechanics of the organisation

The more recent contemporary models contain more steps or stages in the process, but primarily the core of them follows the same logic as Lewin. The table below shows five of the most widely used change models.
<table>
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<tr>
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<tbody>
<tr>
<td>Analyse the organisation and its need for change</td>
<td>Establishing a sense of urgency</td>
<td>Motivating change</td>
<td>Simplification</td>
<td>Surface dissatisfaction with the present state</td>
</tr>
<tr>
<td>Create a shared vision with common direction</td>
<td>Creating the guiding coalition</td>
<td>Creating a vision</td>
<td>Building front-line initiative</td>
<td>Promote participation in change</td>
</tr>
<tr>
<td>Separate from the past</td>
<td>Developing a vision and strategy</td>
<td>Developing political support</td>
<td>Building discipline</td>
<td>Give rewards for supporting change</td>
</tr>
<tr>
<td>Create a sense of urgency</td>
<td>Communicating the change vision</td>
<td>Managing the transition</td>
<td>Embedding support</td>
<td>Provide time and opportunity to disengage from the present state</td>
</tr>
<tr>
<td>Support a strong leader role</td>
<td>Empowering broad-based action</td>
<td>Sustaining momentum</td>
<td>Integration</td>
<td>Develop and communicate a clear image of the future</td>
</tr>
<tr>
<td>Line up political sponsorship</td>
<td>Generating short-term wins</td>
<td></td>
<td>Realigning cross-unit relationships</td>
<td>Use multiple/consistent leverage points</td>
</tr>
<tr>
<td>Craft an implementation plan</td>
<td>Consolidating gains and producing more change</td>
<td></td>
<td>Creating stretch</td>
<td>Develop organisational arrangements for transition</td>
</tr>
<tr>
<td>Develop enabling structures</td>
<td>Anchoring new approaches in the culture</td>
<td></td>
<td>Developing trust</td>
<td>Build in feedback</td>
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<tr>
<td>Communicate, involve</td>
<td></td>
<td></td>
<td>Regeneration</td>
<td></td>
</tr>
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<td></td>
<td></td>
<td></td>
<td>Ensuring continuous learning</td>
<td></td>
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<td></td>
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<td></td>
<td>Integrating the contextual frame</td>
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<td></td>
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<td></td>
<td>Maintaining a dynamic imbalance</td>
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</table>

Table 1: Contemporary Change Models
people and be honest  
  . Reinforce and institutionalise change

<table>
<thead>
<tr>
<th></th>
<th>Leading the renewal process</th>
<th>mechanisms</th>
</tr>
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<tbody>
<tr>
<td></td>
<td></td>
<td>. Assure the support of key power groups</td>
</tr>
<tr>
<td></td>
<td></td>
<td>. Use leader behaviour to generate energy in support of change</td>
</tr>
<tr>
<td></td>
<td></td>
<td>. Use symbols and language</td>
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<tr>
<td></td>
<td></td>
<td>. Build in stability</td>
</tr>
</tbody>
</table>
The Middle Manager

During De Beers strategic transformation the feedback from non-participating employees, including middle management, was that there had been insufficient communication of the review. Middle management is often required to be the messengers and the implementers of a new strategic plan. Kotter\textsuperscript{vi} notes in his highly influential paper (1995) "A few corporate change efforts have been very successful. A few have been utter failures. Most fall somewhere in between, with a distinct tilt toward the lower end of the scale." In most cases middle management are blamed for being the source of resistance. Contrary to this line of thinking is the table\textsuperscript{vii} below that highlights six fatal errors that are made at a senior executive level and that may account for many failed transformation attempts. These fatalities occur when middle managers are viewed as no more than transmission belts for implementing announced changes. It is felt that middle managers that experience strategic transformation in this manner are likely to exhibit apathy and a non committal attitude or, even worse, resistance to the transformation. Argyris (1993) notes that, "resistance among middle managers may only be a symptom of a deeper problem rooted in the intervention models being used by CEOs, senior managers and consultants."

Table 2: Fatal Transformation Errors from Top Management

<table>
<thead>
<tr>
<th>Fatal errors</th>
<th>Consequences</th>
<th>Alternative actions</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Too preoccupied with external events; experience great pressure from the shareholders to perform</td>
<td>1. Ignore internal strengths and dynamics of the organisation</td>
<td>1. Micro-dynamic can generate macro-changes; include middle managers in planning processes</td>
</tr>
<tr>
<td>2. Too general a view of transformation; assume everything must change at once</td>
<td>2. Ignores micro-politics of transformation issues, and management of resistance and emotion</td>
<td>2. Recognise cultural strength of company; pay more attention to strengths than weaknesses</td>
</tr>
<tr>
<td>3. Too much focus on</td>
<td>3. Assumption that middle</td>
<td>3. Mould strategic</td>
</tr>
<tr>
<td><strong>rational change and design strategies</strong></td>
<td>managers are like Pavlovian dogs and will fall in line with the strategic plans emanating from the top</td>
<td>transformation process with desire of employees and involve them - and their fears - in planning and visioning</td>
</tr>
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<td>----------------------------------------</td>
<td>--------------------------------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>4. Assume that charismatic leadership will produce transformation</strong></td>
<td>4. Simplistic assumptions of influence, and recipients usually only have sporadic contact with the 'charismatic' leader</td>
<td>4. Make leadership a collective process involving all the top management acting as role models</td>
</tr>
<tr>
<td><strong>5. Assume that 'Do as I say' will produce strategic transformation</strong></td>
<td>5. Other top managers may only pay lip service to new pronouncements for strategic transformation; reliance on training and incentives programmes are not enough</td>
<td>5. Top management should work alongside middle managers, sponsor their efforts and facilitate action on proposals</td>
</tr>
<tr>
<td><strong>6. Place a burden of change on the 'decentralised' middle managers</strong></td>
<td>6. Perversion of meaning of decentralised whereby top management simply judge the actions of middle managers on their abilities</td>
<td>6. Share burden of strategic transformation; allow external consultants to represent middle managers; and remind top managers of the impact of their actions elsewhere in the organisation</td>
</tr>
</tbody>
</table>
STRATEGIC INFLECTION POINT

The typical organisational lifecycle as portrayed by Stockport (2000) can be shown in a simple drawing of an 'S' shaped curve as presented below.

Figure 1: Organisational Lifecycle - via the Sigmoid Curve

The figure above suggests, that as an organisation grows up and matures to point A (at almost its peak in terms of lifecycle and performance), it will plateau out for a period of time before starting to decline and die as an business entity. Stockport regards point A (a window of time) as the most significant and critical point in the life of an organisation, in terms of strategic transformation. This point was coined in 1997 by Andy Grove, of Intel as the "Strategic Inflection Point." From this point on any strategic transformation would then be seen as reacting to events being played out in the business environment and the potential to drop on past point B and failure would increase substantially. He firmly believes that for a company to successfully transform itself strategically, senior management must make an earlier call to determine where they are on the Sigmoid curve. Where would De Beers have placed themselves? Probably between points A and B on the Sigmoid plateau. It has been suggested in this report that De Beers had actually started to wither at the time of the review and that the company was at point ‘B’ on the curve at that stage.
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