OPINION

DE BEERS' SYNTHETICS

By MARTIN RAPAPORT

De Beers' decision to sell synthetic diamond jewelry raises important issues that are fundamental to the future of the natural diamond industry.

Let us begin by analyzing the role of De Beers in the diamond industry. Until about 2000 and the advent of their "Supplier of Choice" program, De Beers was the custodian of diamonds. They maintained rough diamond prices by buying excess supplies of non-De Beers rough, and they spent about $170 million a year advertising generic polished diamonds. For close to 100 years, this approach worked well. The trade looked up to De Beers as the father of the diamond industry and relied on De Beers to take care of them. De Beers was family.

All that changed in 2000 when De Beers changed their strategy. Australia's Argyle and Russia's Alrosa had dropped out of the cartel, and De Beers found themselves with over $5 billion of inventory and a market cap well below book value. It could no longer afford to buy open-market rough to maintain rough prices, and it could not provide generic advertising to free riders. De Beers was no longer the guardian of diamonds or the diamond trade. It was no longer the "benevolent monopoly" described by Harry Oppenheimer. De Beers transitioned from a family-oriented business that optimized the long term to a corporation that focused on short-term management goals and profitability.

While De Beers is still a dominant diamond player that sells about 42% of the world's rough diamonds, its priorities and future are based on its ability to create profits for its shareholders. De Beers is a corporation with no emotional attachment to diamonds or the trade. Those who believe in De Beers and expect it to protect them and their diamonds are living in the past. While De Beers does take proactive socially responsible measures to build the profitability of its brand, corporations are not altruistic. It's all about profits. De Beers is a corporation loyal to profits, nothing more and nothing less.

SYNTHETIC OPPORTUNITIES

The current situation is very interesting because it highlights the conflict between De Beers' past and future. On the one hand, De Beers has a very large $5.3 billion business selling natural diamonds, with strong relationships and large investments in Botswana and South Africa (see Page 26). On the other hand, the contract with Botswana must be renewed in 2020, and it is likely the government will push for better terms and more diamonds to be sold through its independent Okavango company. Furthermore, South Africa is politically unstable. Who knows what will happen in Africa over the long term?

And then there is the great opportunity of synthetics. An opportunity to create an exciting new market for fashion jewelry based on synthetic diamonds; to sell new diamonds that will appeal to a new generation of millennial consumers; to transcend the stone business by designing, manufacturing and marketing their own jewelry; to use e-commerce to sell directly to consumers, track them and grow them; to transform De Beers from a mining company to a luxury consumer powerhouse.

All this opportunity is made easier by De Beers' position that it is a primary low-cost synthetic diamond producer with detailed knowledge and expertise about the demand side of the diamond equation.

> "DE BEERS CAN'T DANCE AT TWO WEDDINGS AT THE SAME TIME"

“THERE IS A DIFFERENCE BETWEEN WHAT IS GOOD FOR DE BEERS AND WHAT IS GOOD FOR THE NATURAL DIAMOND INDUSTRY”

From De Beers' perspective, synthetic diamonds are an opportunity they cannot afford to miss. They believe that they can maintain a dominant and profitable position in both natural and synthetic diamond markets. Furthermore, a future in synthetics makes them less reliant on natural diamonds and puts them in a better negotiation position should they have "Africa problems." From a strategic perspective, why should De Beers' profits be limited to what comes out of the ground?

CONSEQUENCES

De Beers is quick to point out the positive consequences of their synthetic move. They claim their straightforward $800-per-carat pricing model will force other synthetic diamond producers to significantly reduce prices and possibly go out of business. Theoretically, De Beers is pushing back against synthetic diamond producers that have been free-riding on the historic allure of natural diamonds. These parasites have been gaining windfall profits by selling their synthetic diamonds at a discount price to natural diamonds. They have been getting a "scarcity premium," even though their synthetics are not scarce. Their windfall profits are then used to increase and improve digital marketing aimed at new-age diamond consumers.

The problem with De Beers' synthetic strategy is that De Beers can't dance at two weddings at the same time. Synthetic diamond fashion jewelry competes directly with natural diamond fashion jewelry. There are plenty of small natural diamonds (melee) priced at $800 per carat or less. Why is De Beers directly competing with the natural diamond fashion jewelry business? Does their research tell them that young women prefer synthetics to natural diamonds? The government of Botswana should be asking De Beers: Where is your exciting new marketing program for natural diamond fashion jewelry?

The most important thing to understand is that wherever and however De Beers promotes and sells synthetic diamonds, they will be competing directly with natural diamonds. Furthermore, their claim that lower prices will push out or reduce profits of other synthetic producers only applies if they directly compete against the specific product categories of the other producers. Most of the producers are not in the fashion jewelry business; they are going after the engagement ring market. De Beers will have to go into the synthetic diamond engagement ring market. Otherwise their claims of economic benefit to the natural diamond industry are extremely limited to fashion jewelry.

And so, we now get to the heart of the diamond business – the diamond engagement ring. Essentially, there is a trade-off between a woman's preference for a natural diamond vs. her preference for a bigger diamond. While size is not as important to everyone, there are many women and men for whom size is more important than whether or not the diamond is natural. The more De Beers lowers the price of synthetics, the greater the size value of synthetics, and the more diamond demand shifts from natural to synthetics. Let's do the math.

Consider a couple with a $2,000 engagement ring budget for a round, I, SI2 quality diamond. A jeweler with a 30% margin. And a mounting from the jeweler to the couple costing $200. That leaves $1,260 for the diamond at wholesale prices. Using RapNet best prices and De Beers' $800-per-carat synthetic price, the choice to the consumer would then be a 0.70-carat, I, SI2 or a 1.57-carat synthetic. That's a 124% size difference.

Now consider a couple with a $5,000 engagement ring budget for a round, I, SI2 quality diamond. A jeweler with a 30% margin. And a mounting from the jeweler to the couple costing $500. That leaves $3,150 for the diamond at wholesale prices. Using RapNet best prices and De Beers' $800-per-carat synthetic price, the choice to the consumer would then be a 1.10-carat, I, SI2 or a 3.93-carat synthetic. That's a 257% difference in size.

It should come as no surprise that the lower the synthetic price, the greater the demand for synthetic diamonds at the expense of natural diamonds. The decision, "Do you want it real or do you want it big?" may depend on how much bigger. De Beers' move into synthetics, combined with an aggressive marketing program, legitimizes synthetic diamonds as a viable alternative to natural diamonds. If they push lower synthetic prices into the engagement ring market, they may kill the parasites and the natural diamond market along with them. If they do not go into the engagement ring market, the net result of their synthetic efforts will be to give credibility to the parasites. From the perspective of the natural diamond trade and mining companies, De Beers' synthetic diamond marketing and pricing approach looks like a lose-lose situation.

If De Beers extends their synthetic strategy to the diamond engagement ring market, we expect natural diamond demand and prices to head south. The natural market can probably withstand their synthetic efforts in fashion jewelry, as natural inexpensive melee can compete.

However, when it comes to engagement rings and bigger diamonds, De Beers' efforts to lower synthetic prices may significantly damage the natural market. ▸

“DO YOU WANT IT REAL OR DO YOU WANT IT BIG?”

We may be better off with the parasites than with De Beers synthetics.

WHAT SHOULD WE DO?

We should recognize that there is a difference between what is good for De Beers and what is good for the natural diamond industry. This does not mean that De Beers is evil, it just means that they are a corporation with a different perspective and agenda.

Right now, it looks like they are married to two wives and we are the old one. While there is room for both products, it is likely that whoever markets best will gain market share. It's sad to see De Beers marketing against natural diamonds.

We have deep concerns for the artisanal diggers and the African mining companies, and strongly denounce those that claim synthetic diamonds are more ethical than mined diamonds. It is vital that the mining companies move quickly and decisively to market, brand and source-certify their natural diamonds. It is vital that they do so with partners that do not have conflicts of interest.

As to retailers, it's time to carefully consider who you are and what you sell. While synthetic diamonds may not hold value due to a lack of scarcity, there is no denying that some of your customers will want size over scarcity. In the end, it's your decision what to sell. As long as you are totally honest with your customers, there is nothing wrong with selling synthetics, but be sure to let consumers know that synthetics are not scarce and that their prices will most likely fall as technology advances. It should be clear to you and your customers that synthetics are not a substitute for real diamonds, because they are incapable of holding value.

> "BEING REAL IS NOT EASY, BUT IT'S THE RIGHT THING TO DO"

When all is said and done, synthetics are a different product. Once they get cheap enough, say, like synthetic emeralds and rubies, they will not be a competitive challenge to real natural diamonds. However, until then – watch out.

In the end, each of us will have to answer the key strategic question: Should our profits be limited to what comes out of the ground?

If the most important thing to you is profit, then go ahead, sell anything to anyone at any price. However, if you and your business have real values that transcend profits, take a pass on synthetics.

You might miss out on business and make less money, but you will build confidence in who you are and what you sell. Being real is not easy, but it's the right thing to do. ■

DE BEERS ROUGH DIAMOND SOURCING

Based on De Beers reports and Rapaport estimates

Company	Production value ($ Millions)	% of total	Average price ($/ct.)	Production by mine (Cts. '000s)	Production by division (Cts. '000s)	% of total
Debswana (Botswana)	$3,607	59%	$159		22,684	68%
- Orapa				10,185		
- Jwaneng				11,857		
- Letlhakane				607		
- Damtshaa				35		
Namdeb (Namibia)	$973	16%	$539		1,805	5%
- Offshore				1,378		
- Land-based				427		
De Beers Consolidated Mines (South Africa)	$672	11%	$129		5,208	16%
- Venetia				4,602		
- Voorspoed				606		
De Beers Canada	$883	14%	$235		3,757	11%
- Gahcho Kué				3,033		
- Victor				724		
Total	$6,134		$183	33,454	33,454	