Study-Group Role-Playing Exercise:

Forever?

De Beers' Strategic Review of 1999:

Should De Beers Abandon Its Time-Honored Strategy?

On Tuesday, December 4, we will reenact an historic meeting of the Board of Directors of De Beers, the South African diamond company. The purpose of this exercise is to use the microeconomic theory we have learned throughout the semester for a more open-ended question. The question is based on a real event in the history of De Beers, the South African diamond company. For more than a century De Beers had monopolized the world sales of diamonds by organizing and defending an international cartel[1] in the sale of rough diamonds. The case study "Forever: De Beers and U.S. Antitrust Law," describes how they did it and sets up the dilemma that company management faced in the late 1990s. Was it time for a radical change, or not?

1. Setting: Meeting of the Board of Directors of De Beers

The date is some time in 1999. On the agenda is a single issue: Should De Beers continue its policy of defending the Diamond Cartel, or should it abandon that time-tested practice and adopt a new proposed aggressive marketing strategy of exploiting the De Beers brand?

The New Proposal

New blood in the executive board has placed a new proposal on the table:

> De Beers should abandon its policy of collaboration and begin a policy of competition. Its strong brand name and "brilliant" history of marketing places it in a unique opportunity to exploit the brand name and differentiate De Beers diamonds from other diamonds.

There are a number of reasons, the proponents argue, that this new strategy makes sense:

- Most immediate, the company is facing financial troubles. The root causes are in the company's traditional practice of accumulating stockpiles of diamonds to stabilize the world price of diamonds. Those stockpiles have grown significantly since 1978 (See Exhibit 6). The reason is that since 1977, De Beers has had to "defend"[2] the world price of rough diamonds from the repeated defections of other members of the cartel – Zaire,

---

[1] Since 1925, De Beers had operated a cartel based on a two-pronged strategy. First, they negotiated contracts by which all the major rough diamond sellers in the world sold all their production to De Beers, which gave De Beers a monopoly in the distribution of rough diamonds to retailers, even though De Beers did not have a monopoly in their production (mining). Second, they maintained stockpiles to "defend" the price of diamonds. (See note 2.)

[2] "Defending" the price refers to their policy of stabilizing the price. Since production each year varied by the richness of the veins being exploited and any new discoveries, supplies could vary and affect the price of diamonds. To avoid abrupt downward movements in the price, they would buy up supplies in years of abundant production and hold them in stockpiles. Then they would release some diamonds from their stockpiles in years of lean production to smooth out sale and stabilize the price.

Russia, Angola, Australia. The defection by others and defense by De Beers has two consequences.

   a. First, buying and holding larger stockpiles must be financed. The financing costs are a function of the size of the stockpiles, the price paid for them, and the rate of interest.

   b. Second, when another country defects, it increases its sales, therefore its market share, at the expense of De Beers (and other compliant cartel members). The numbers speak for themselves. Until 1977, De Beers' had 80% of the world market. Its market share has since fallen to around 60%. Under the current policy, proponents of change argue that the share will continue to fall.

- The recent review of company strategy conducted by Bain and Company, the well-known managerial consultants, concluded that De Beers has an latent competitive strength—it has one of the world's most recognized brand names, a "brilliant" history of marketing, and slogan voted by *Advertising Age* as the "Slogan of the Century." Since the history of the company, diamonds have been sold as a homogeneous[3] commodity. Their brand name offers De Beers a unique opportunity to differentiate its diamonds from their Australian, Russian, and Angolan stones. Branding has the potential of increasing their market share and reducing the stockpiles.

The Opposition Within the Organization:

Opponents to the strategy argue that moving away from the strategy of collaboration the company has supported for more than a century is a dangerous and risky strategy—a voyage into *terra incognita*—too risky to be sound. Two questions loom over the new proposal:

- What would happen to diamond prices if De Beers started to compete instead of collaborate?
- What would all of this turmoil do to the industry's carefully nurtured illusion of the diamond as a scarce and luxurious commodity?

The opposition argues that these questions are unanswerable. They argue for a more sound, conservative strategy based on time-honored and predictable practices. A century of success at De Beers suggests that they must be doing something right. With such a record, a radical change in the business strategy, as proposed, is not sound policy.

What Should You Do?

Each Study-Group is assigned a role within this debate. Go to the course website to find out what your role is. Find out the other roles, too. Your group should prepare a case to present to the Board of Directors that emphasizes the economics or the logic of the strategy of your position. Use the data, details, issues, history, etc., from the case study, "Forever: De Beers and U.S. Antitrust Law," to prepare your case. You will have no more than 10 minutes (you may take less) to make your case to the Board of Directors (that is not much time, so be concise, to the point, and clear). Make sure your analysis is easy to understand and aimed at the level of knowledge of the Board, which will be made up of your peers—all, by now, experts in intermediated

---

[3] Diamonds had always been treated as a homogenous commodity. Not all diamonds were alike. They were graded and assessed for value by dealers, but before this proposal, no one had suggested branding diamonds, that is, differentiating diamonds by the firm that produced them.

microeconomic theory. Select one person to represent your group, and one assistant, to make the presentation before the Board. Also select alternates, in case someone is sick that day. Prepare thoroughly, but also be prepared to have to think on your feet or make some statements impromptu—you may need to respond to others' presentations or answer questions from the Board.

Unfortunately, not all groups will have the opportunity to give their presentations. On the day of the presentation, I will randomly select one group assigned to each role to present their cases.

All remaining persons in the room are on the Board of Directors. I expect the groups that are not picked to lead the discussion of the Board of Directors, asking questions of the presenters, and reaching some conclusion(s) after all presentations have been made. All members of the Board are encouraged to engage in discussion. Amendments to the proposal—say to collect specific information—may be proposed and voted on. I will mediate but will not vote or engage in the discussion. At the end, the Board will vote on whether to adopt the new policy or not, conditional on any amendments that may have been attached to the proposal.

The Agenda for the Meeting

The agenda for the Board meeting on Tuesday, December 4, is the following:

1. Welcome (by presiding non-voting officer, Dr. Dye)
2. Report of the Non-Partisan Task Force on Continuation of the Cartel
3. Report from the Proponents of the New Proposal
4. Report of the Legal Department on the ramifications of U.S. Antitrust Policy
5. Report from the Opponents of the New Proposal.
6. Report of the Minority Shareholders' Group
7. Open the Floor for Discussion Among Board Members and Opportunity to Propose Amendments to the New Proposal
8. Majority-Rule Vote of the Board of Directors. Yea for the New Proposal, or Nay for the Status Quo.

Visual Aids

Visual aids may be useful. You may prepare PowerPoint Slides, but if you intend to use them, it is necessary that you email them to me by Monday morning, December 3, to give me time to assemble them. I will prepare PowerPoint slides of all the Exhibits in the Case Study, in case you wish to refer to them. (Please let me know in advance if you have plans to use them.) Also I will be happy to convert any figures you may wish to display into PowerPoint, as long as you let me know by Sunday, December 2, so that I have Monday to prepare them.

Some Highlights

You should learn about your position, the details and issues of the case from reading the case study. The entire case is relevant, but there are a few issues that I wish to highlight and provide some brief interpretation.

- Signs of trouble began in the 1970s and 1980s, but they did not build into problems for De Beers until the late 1990s. In 1977, the first of a series of significant defections from the De Beers cartel occurred. Other defections occurred in the 1980s and 1990s. De Beers' response to these defections was to "defend" the price and the cartel by letting their stockpiles grow by buying up large quantities of diamonds from the market to counteract the increased supplies "dumped" on the market by the defectors.
- Growing stockpiles were a consequence of De Beers' response to the defections. You can see the dramatic increase in De Beers' stockpiles in Exhibit 7. These stockpiles create higher costs because they must be financed. These stockpiles represent non-earning assets of the company.
- The company raised some of the funds to finance the growing stockpiles by issuing equity (shares) more widely. Historically, the company was closely held—meaning the shareholders were primarily family and trusted associates with a managerial as well as a stockholders' stake in the company. The change in composition of shareholders is significant. In order to raise funds to finance the stockpiles, they have sold a significant share of the company's equity to shareholders who do not have a stake or personal relationship with the family-dominated management of the company. Their interests are more strictly as shareholders who will want to see the returns to their investment maximized. They will also have representation on the Board of Directors and will attempt to influence company policy to pursue their interests.
- New management (under the leadership of Nicky Oppenheimer and Gary Ralfe) is young and less committed to tradition. It is not clear whether the majority of the Board of Directors is in their camp, the traditionalist camp, or yet undecided.
- Hiring of management consultants, Bain and Company, to do a wide-ranging strategic review was a landmark event for De Beers. The company had a history of being secretive. Financial Director Paddy Kell said that "only a few years ago the use of external consultants would have been heresy." Bringing an outside consultant to review the company was a radical departure from tradition.
- The Strategic Review. "The company has to decide whether it was in business for itself or for the diamond business as a whole." Defending the cartel over the last several decades has meant that De Beers inordinately bore the costs, by stockpiling and accepting a greater burden of production restrictions, but the gains from doing that are spread more equally among all diamond producers. Challengers to that policy say that it is time for De Beers to reap the gains of its policies.

Why are we doing this?

- In the real world, the answers to economic problems are often less cut and dry than they appear in theory because the details are messier and our information is imperfect. This case offers an opportunity based on a real event to see how the theory can be useful to sort out the issues when the question is more open-ended.
- I am a believer in experiential learning, and this is an example of it. Re-enacting this important event in the history of De Beers, if you get into it, will bring some of the theories we have discussed and its usefulness to life for you. Of course, you will only get out of it what you put into it.

- As an incentive, the best group will have the privilege of excluding the material of one lecture, covered by one of the midterms—the lecture of your choice!—from the final exam.