Power struggle

Separation of power – or lack thereof – in the rough diamond industry is worth closer inspection

Paul Zimnisky
New York, US

For the majority of the 20th century the diamond industry was conspicuously controlled by De Beers, which hoarded over 80% of the world's rough diamond supply in an attempt to manage global supply and thus prices. However, a series of events over the past two-and-a-half decades have reduced De Beers controlling share to 35%.

In a monopoly one seller dominates the entire market. In an oligopoly a small number of large sellers dominate the market.

While an oligopoly does consist of multiple players, the sellers can still individually set production quantities and prices and significantly influence the market.

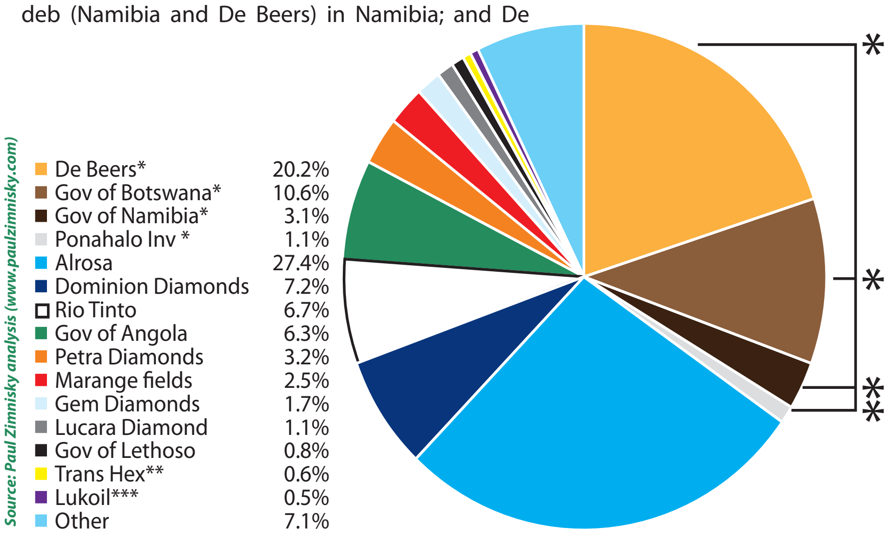
When discussing the presence of a monopoly or oligopoly, seller is the key word, and even though most diamond mines have multiple owners, usually only one entity manages the operations of the mine including diamond sales.

"A series of events over the last two-and-a-half decades have reduced De Beers controlling share to 35%"

It is important to distinguish this since the potential for pricing power comes from having a significant enough stake in supply relative to the industry as a whole, thus creating the opportunity for price leverage.

To put this into context, De Beers is 85% owned by Anglo American plc and 15% owned by the Botswana government.

Most of De Beers' mines are jointly owned by it and the country in which the operations are taking place. Technically the mines are owned by subsidiary companies jointly owned by De Beers and the respective government such as the cases of Debwana (De Beers and Botswana) in Botswana; Namdeb (Namibia and De Beers) in Namibia; and De Beers Consolidated Mines (De Beers and Ponahalo Holdings Ltd – a Broad-Based Black Economic Empowerment) in South Africa.



**DTC is the selling entity for De Beers and its partners, encompassing all of the bracketed sections on the chart and equating to 35% of global rough diamond selling. The chart shows DTC broken down between De Beers, the Government of Botswana, the Government of Namibia, and Ponahalo Investment Holdings to show that De Beers does not own the entire inventory that DTC sells. **Trans Hex is a public company trading under the symbol TSX on the Johannesburg Stock Exchange. ***Lukoil is a public company trading under the symbol LKOH"on Russia's RTS Exchange. NB: All figures are based on estimated total value of diamonds held by selling entity from ROM*

While the ownership split of these subsidiaries is 50:50, all of the diamonds produced are sold via De Beers' distribution system DTC, or Diamond Trading Company.

De Beers' partners – the governments – do have an ownership stake in DTC as well, but the DTC entity has pricing power because holistically it controls the selling of an estimated 35% of global diamond production.

DTC sells the large majority of its diamonds to a pre-selected group of buyers referred to as Sightholders via 10 organised sales a year referred to as Sights.

De Beers sets the selling price for the diamonds sold at Sights, which are sold on a take it or leave it basis.

Even with no price flexibility, Sightholders are loyal because they view the quality and quantity of diamonds offered by Sights as unmatched.

For DTC, offering a reliable diamond supply translates into loyal customers, which in turn translates into pricing power for De Beers. De Beers will adjust the quantity of supply offered via DTC in order to match demand, which has allowed it to keep offering prices very stable, albeit with a moderate upward trend.

Other major players

The second-largest rough diamond selling entity in the world by value is OJSC Alrosa. The diamond miner's domestic mines were wholly owned by the Russian state and local governments and related administrations before going public last year and carving out a publicly traded float of approximately 23% of the company.

Alrosa sells 50-70% of its domestic production via long-term contracts, which work in a similar manner to DTC's Sightholder system.

The balance of Alrosa's diamonds are sold via auctions, other bidding systems, and one-time contracts.

Alrosa sets the price of the diamonds that it sells via long-term contract, and their buyers are loyal

Focus: Diamonds

for the same reason as Sightholders: the diamond supply is reliable and high quality.

Apart from De Beers and Alrosa, there are six other entities that control the selling of at least 1% or more of global diamond supply: Dominion Diamond Corp (DDC), Rio Tinto, the government of Angola, Petra Diamonds Ltd, the Marange fields, Gem Diamonds Ltd, and Lucara Diamond Corp. Most of these entities sell their diamonds via tenders, auctions and spot sales.

Currently DDC and Rio Tinto are estimated to control 7.2% and 6.7% of global supply respectively. While both companies have interests in more than one diamond mine, they share production from Canada's largest producing and most profitable mine, Diavik.

While Rio is the operator of Diavik, the mine provides physical production for both Rio and DDC in accordance with a joint-venture split, which is 60:40 respectively.

According to Rio, the diamond-price discovery process is agreed upon between both companies and the respective shares of physical production are sold independently.

The calculated market share numbers in the pie chart (*see page 27*) above reflect Rio and DDC's sellable rough diamond inventory share, not the cumulative ownership share in their mines.

The government of Angola is the seventh-largest diamond producing country in the world, and one mine, Sociedade Mineira de Catoca (Catoca), represents over 75% of the country's production. Alrosa owns 32.8% of Catoca, however, Angola's state-owned trading company, Endiama E, also owns 32.8% of the mine, operates the mine and manages all of its diamond sales, according to Alrosa.

In this case Alrosa does not receive physical delivery of diamonds from the Catoca mine, and instead receives straight revenue after the diamonds are monetised. Thus, Alrosa's 32.8% stake in Catoca is not reflected in the company's global market share number of 27.4%.

"Rough diamond supply sold by tenders, auctions, and spot sales tend to reflect the true market value for rough at any given time"

Petra Diamonds operates six mines in Africa, and owns a 74-75% stake in all of the mines. According to Petra, the company manages 100% of the mine operations across the entire chain, from mining to sales.

Its partners are in effect passive partners and receive their share in straight revenue after the diamonds are sold. Given this structure, Petra controls 100% of the diamond selling from its six mines, equating to a 3.2% share of global rough diamond sales.

The Marange fields are comprised of almost $500km^2$ of alluvial diamond mine in eastern Zimbabwe.

The fields are primarily operated by seven commercial producers, which recently began collectively selling their diamonds in organised selling events in Antwerp and Dubai, representing 2.5% of the global market in terms of value.

Rough diamond supply sold by tenders, auctions and spot sales tend to reflect the true market value for rough at any given time, and thus these prices influence De Beers and Alrosa when they set prices for Sights and long-term contracts.

The two largest players in the industry represent a powerful market share of 62.5% and discretionally set selling prices for most of their diamonds.

The next three-largest entities combined represent another 20.2% of market share, but tend to use more of a "market dictated" process to price their diamonds.

Is the rough diamond industry a monopoly, oligopoly, or neither? I will leave that for you to decide. ▼

Paul Zimnisky is an independent analyst and consultant. This article originally appeared on www.paulzimnisky.com. At the time of writing the author held a long position in Stornoway Diamond Corp