

## COVER

# ROUGH BUBBLE BUST

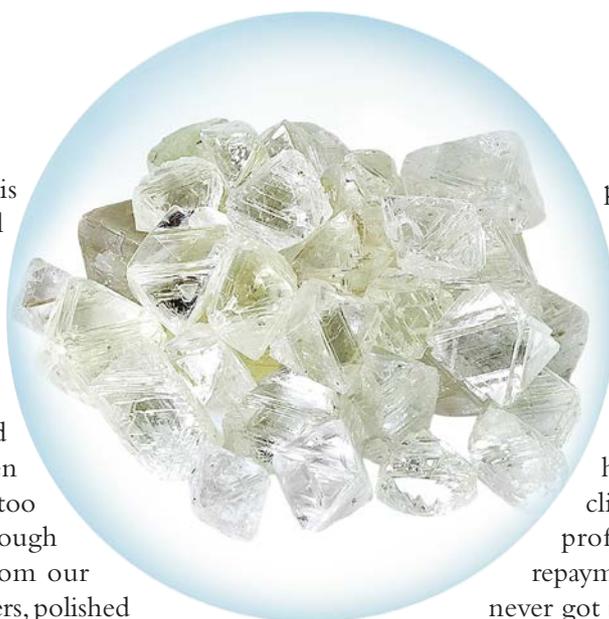
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 BY MARTIN RAPAPORT

The diamond industry is undergoing fundamental structural change as the rough diamond distribution system self-destructs amid collapsing rough prices. Frankly, it's good news. Unprofitable, unsustainable and unfair rough prices have been the bane of our industry. For too many years artificially high rough prices have stolen profits from our trade. The hard-working cutters, polished dealers, jewelry manufacturers, designers and retailers who have honestly added value to diamonds have not received their fair share of diamond profits.

The major mining companies and the banks have milked our trade dry by systematically supporting rough prices that were significantly higher than polished prices. This effectively moved profits from the trade to the miners. The banks helped the miners squeeze profits out of the trade by showering money on firms that boosted rough prices to speculative unprofitable levels. The overextension of credit created a situation similar to what happened in the Real Estate Bust of 2008. Too much credit created a price bubble that burst when it became clear that the value of the underlying assets was insufficient to repay loans.

In the case of the diamond industry, the banks were complicit in the creation of the rough price bubble because they consistently lent money to buy unprofitable rough diamonds. As in the case of the real estate bust, the banks were more interested in their short-term



profits than the ability of their clients to repay loans. Once it became clear that the clients did not have the assets to repay the loans, the bankers chose to continue the loans as long as the interest payments were made. They hoped that at some stage their clients would accumulate huge profits that would enable loan repayment. But the rough borrowers never got the big profits. De Beers and the other mining companies kept raising prices whenever polished prices increased so cutters remained unprofitable and instead of a polished boom, we now have a rough bust.

De Beers, ALROSA and the other mining companies were beneficiaries of the banking boondoggle. They took short-term profits without thinking about the long-term negative implications of their relentless price hikes. Essentially, money was moving from the banks to the mining companies in a Ponzi scheme environment involving overpriced rough diamonds supported by diamond cutters who took the money from the banks and gave it to the mining companies. Some cutters also took their cut by setting aside some of the money the banks so generously gave them. None of the players who benefited from this game were innocent. Nothing supported the high rough price levels other than even higher rough prices supported by unsustainable loans.

The real victims are the legitimate diamond trade that could not make profits adding value to diamonds because

the rough Ponzi game left no room for profit. Companies that relied on real rather than Ponzi scheme profits could not buy rough and make a living from cutting it. They and their customers and their customer's customers, were pushed out of the diamond business due to the unfair high rough prices created by the Ponzi-playing banks and mining companies.

### **PERFECT STORM, NOT THE REAL PROBLEM**

It is important not to confuse short-term demand issues with long-term fundamental structural change driven by the rough bust. The sharp decline in diamond demand caused by a "perfect storm," the result of macroeconomic events, is not the real problem. Decreasing Chinese demand, a weak euro and ruble, plummeting oil and commodity prices are all important and will change where, how and to whom we sell diamonds. But we must recognize that perfect storms by their very nature come and go. Firms that weather the storms return stronger as the storm blows away inefficient competition. The real issue is the impact of the rough bubble bust and the collapse of the sightholder system, which is changing diamond pricing and distribution.

Many decision makers mistakenly believe that the trade can simply wait out this storm and things will go back to normal. But that is not going to happen. The rough bubble has bust. The banks are out of the game and the cutters are out of money. Distribution profits are too low to support industry-wide diamond marketing and sales. We have a serious problem that requires proactive measures.

Warren Buffet famously said, "Only when the tide goes out do you discover who's been swimming naked." Now that the perfect storm has taken out the tide we can see that the De Beers emperor is not wearing any clothes. The sightholder system that forced companies seeking reliable supply to overpay for rough diamonds, build nonprofitable factories and ineffectively market diamonds is kaput. The banks that recklessly supported the financing of unprofitable diamond manufacturing are going to lose billions of dollars. Bankruptcies and bouncing checks are on the horizon. The companies that "absorbed" the bank's money through fictitious inventory accounting, speculation and transfer-pricing schemes can no longer game the system. The proverbial poop is hitting the fan.

### **BACKGROUND STORY**

Once upon a time there were ministers and bankers that thought they could increase employment in the diamond manufacturing sector and help the diamond industry by lending lots of money to lots of cutters. So they did. The more rough diamonds the cutters bought, the more bank money they got. So the cutters bought lots of rough and got lots of money. The banks made good profits on the loans so everyone was happy.

The cutters didn't care if the price they paid for the rough was too high because it didn't matter if they made a profit. All that mattered was that they kept getting more money. They did not buy rough to make money cutting it, they bought rough to get money from banks. This went on for years. As long as the banks kept profiting from interest payments, they turned a blind eye to the issue of whether or not the money they lent would ever be returned. The cutters figured they could just keep rolling over their debt and would never have to return the money. After a while they considered the bank money their own money, investing it or spending it wherever or however they liked.

And so a great rough diamond bubble developed. As long as the rough kept flowing, the loans kept flowing, the interest payments got made and the bubble grew bigger and bigger. In this Ponzi scheme the mining companies made out like bandits because it did not matter if rough prices were too high. Rough was simply an excuse to get money.

“The trade is giving up on diamonds as a realistic way to make a living.”

## 2014 ROUGH DIAMOND SALES

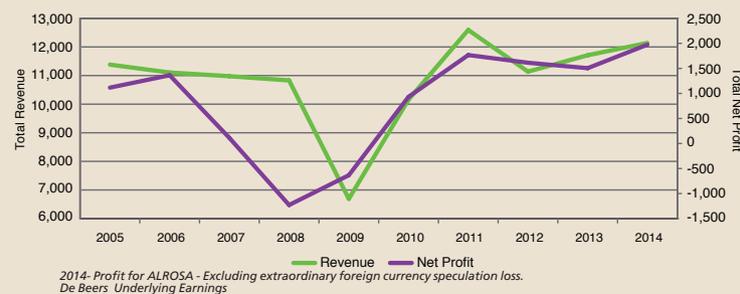
COMPANY	Rank	Share %	Million \$	Million Carat	\$/Ct
De Beers	1	46%	\$6,494	32.7	199
ALROSA	2	35%	\$4,886	39.6	123
Rio Tinto	3	6%	\$901	13.9	65
Dominion	4	6%	\$817	4.8	169
Petra Diamonds	5	4%	\$502	3.1	161
Gem Diamonds	6	2%	\$277	0.1	2,540
Lucara Diamond	7	2%	\$266	0.4	644
Kimberley Diamonds	8	1%	\$90	0.1	724
Other		4%	\$555	32.9	17
<b>Total</b>		<b>100%</b>	<b>\$14,787</b>	<b>127.6</b>	<b>116</b>

Source: Rapaport estimates based on Kimberley Process (KP) statistics.

## ROUGH & POLISHED DIAMOND PRICES



## DE BEERS, ALROSA COMBINED TOTAL REVENUE & NET PROFIT (\$MIL.)



## DE BEERS SIGHT SALES (\$MIL.)



The rough diamond Ponzi scheme had a disastrous effect on legitimate diamond cutters. The price of rough was pushed so high that no legitimate cutter could buy rough, polish it and sell at a profit. For years rough prices were higher than polished prices. Desperate cutters trying to stay in the business kept losing money. They had to compete in a nonlevel playing field against cutters that got “free money loans” that enabled them to pay any price for rough and sell the polished for a loss to keep the Ponzi game going. Legitimate people had to stop cutting rough and distributing polished because the Ponzi players bought rough high and sold polished low.

Adding insult to injury, the banks also lent money to polished exporters who exported diamonds to their relatives and friends overseas. Polished diamonds went to Belgium, New York and Hong Kong with new loans at almost every destination. In some instances the diamonds were smuggled back into India so the lending cycle could run again and again. All these shenanigans destroyed the level playing field and profitability for legitimate companies.

Increased international government bank regulations also entered the environment. Banks now had to become more responsible, hold greater reserves for riskier diamond debt and formally evaluate portfolio risk. Many stopped new loans to diamond companies, others exited the diamond business altogether. Money started getting very tight.

And then came the “perfect storm.” Demand and revenue plummeted, polished inventory went sky high. Cutters ran out of money and had to stop buying rough, loans stopped. Some cutters do not even have enough money to pay the interest fees. The Ponzi scheme rough diamond bubble burst.

## ACCOUNTABILITY

The perfect storm has created a perfect opportunity to restructure the allocation of profits in the diamond trade. By now, everyone, especially the mining companies and banks, must realize that they can’t milk the diamond trade while starving it of generic advertising and strangling it with high rough prices that ensure no profitability.

We must recognize the tremendous damage that the Ponzi players — mining companies, bankers, speculative diamond borrowers — have done to our industry. They created an unlevel playing field that punished and stole profits from legitimate people who add value to diamonds. Why should anyone strive to find new and better ways to promote and sell diamonds, if the profits from their hard work always go back to the mining companies?

A great threat to the diamond industry is that the mining companies have exploited the legitimate diamond trade for so long that the trade is giving up on diamonds as a realistic way to make a living. The mining companies are killing the goose that lays their golden eggs. They have destroyed the incentive of the people most vital for the growth and development of the diamond industry. The most common question I am being asked is: Should my kids remain in the diamond trade, is there a future for us?

It looks like De Beers has been playing a double game and two-timing the diamond trade. They have been consistently perusing the idea that they can make more money cutting the diamond trade out and selling their diamonds directly to the consumer. Since they cannot do this completely and quickly, they have been using the diamond trade in a transitional capacity. Milking us and our banks, starving us from advertising and strangling us with high prices. This is because we are not part of their long-term strategic plan and are therefore expendable. Frankly, if they plan to cut out the trade it is in their interest to weaken us so that we will eventually disappear.

De Beers, tell us the truth, thousands of diamond manufacturers, wholesalers and retailers are dying to know: Are you planning to cut the trade out of the diamond business? Are you planning to sell your diamonds without us? What role do you see for the traditional diamond trade in your long-term strategic plan? Are you for us or against us? Is there a future for our children in this business?

## **SOLUTIONS**

So how do we get out of this mess? While a comprehensive plan detailing all the necessary initiatives is beyond the scope of this article, there is one vital emergency measure that must be taken.

The mining companies must urgently inject profitability into the diamond trade, by immediately reducing rough prices by 30 percent to 50 percent.

## **DISCUSSION ISSUE 1**

Many in the trade oppose lower rough prices because they think this will not increase demand. They miss the point that the primary reason for the rough price drop is to rapidly and effectively increase profits and liquidity in the trade. An increase in demand due to a rough price drop is an added benefit.

If we don't pump money into the trade quickly there is significant risk that a lack of liquidity will result in a cascade of bankruptcies that will cause a severe drop in polished prices. Much better to have rough prices fall than polished prices. We also run the risk of an additional collapse of confidence by the diamond trade. Drop prices now and you can manage the situation. Don't drop prices now and the situation will manage you.

If there are no profits in the diamond manufacturing and distribution system, why should any bank lend money or any person invest their own money in the diamond business? Frankly, why should diamond people that stashed their personal money in foreign bank accounts, bring that money back into the industry if there are no profits? No profits mean no money and no business. Profits mean we can get the ball rolling again after this disastrous rough bubble bust. The De Beers November 2014 sight was \$527 million, the November 2015 sight was about \$70 million. What does that tell you?

When the 2008 real estate bubble burst the reaction by the U.S. Federal Reserve Bank was to flood the market with liquidity to ensure survival of the markets. It worked. Around the same time rough prices fell by 48 percent and the diamond market recovered. The same thing needs to happen here and now.

“The mining companies must urgently inject profitability into the diamond trade.”

## DISCUSSION ISSUE 2

Some inventory holders believe that if the mining companies drop rough prices, market competition will lower polished price levels across the distribution system. They claim there will not be any extra profits for the trade. They also fear that that polished prices to consumers will drop and everyone will lose inventory value.

This argument is false. While competitive forces are always at work in free markets, there is no reason to believe that polished diamond prices will fall at the same rate as the rough prices, or even fall at all. If Indian diamond cutters drop polished prices because they are under stress then savvy dealers in Israel, New York and Hong Kong will significantly increase their inventory holdings and make extra profits on memo sales. The shortages that are developing due to a 50 percent or greater decline in rough purchases and manufacturing provide a great opportunity for increasing trade profitability if, and only if, new rough is priced in a way that enables profits. Keeping rough prices artificially high in a half-dead market to force polished prices upward is the exact opposite of what needs to be done.

The idea that retailers will automatically drop their prices when rough prices decline is also false. When gold prices come down, retail jeweler profits increase; the same is true for diamonds. Retailers are smart. They do not give away profit margin that can go to the bottom line or be used to increase marketing spend that will gain them market share.

Consider the following quote from Signet's last call with analysts. "...it's when we get into the sustained lower pricing or a sustained change in pricing that we start to see it come through the P&L, which is really the case on the gold side. We've now, for a good year now, we've been seeing the lower gold cost, and that is driving the benefits in our income statement."

The undeniable fact is that lower prices increase retail jewelry profits and/or advertising spend, which in turn increases diamond demand. While the price elasticity of diamond demand is a highly complex subject, there is no question

that lower rough prices will increase profitability in the trade. Furthermore, it will increase the profits of the most efficient players who have the greatest ability to increase diamond demand. People in the diamond and jewelry trade are not fools, given the opportunity they know how to make money legitimately. Lowering rough prices is a no-brainer.

There is a fundamental problem about how some members in the trade think about diamond prices. Some think the only reason that diamonds have value is because De Beers creates artificial prices. That is not true. Diamonds are valuable because consumers desire them as the ultimate luxury that symbolizes love and commitment. It's high time for the diamond trade to get over their insecurity about the value of diamonds. Let me say this straight out. If you do not believe in the emotional and scarcity value of natural diamonds then get out of our trade. The sooner you and your insecurity are gone the better for all of us.

A discussion about additional solutions and initiatives to enhance liquidity and ensure sustainable profitability in the diamond trade are beyond the scope of this article. The Rapaport Group is moving forward with a number of such initiatives. Firms seeking advice may contact us via email at [consulting@rapaport.com](mailto:consulting@rapaport.com).

### NUMBER OF U.S. RETAIL JEWELRY STORES



Source: Jewelers Board of Trade (JBT).

## CONCLUSION

The greatest threat to the diamond industry is that the mining companies will continue to ignore the needs of the trade. They will keep their rough prices higher than polished, starving the diamond trade of vital profits and liquidity. More and more cutters will stop cutting, diamond supply will plummet, more dealers and retailers will leave the industry, forever.

Diamond prices will recover depending on the level of demand and scarcity. But who will sell these diamonds once the trade has been destroyed? Who will romance diamonds and make them exciting? Who will design and delight with diamonds? Who will proudly show off diamonds in tens of thousands of showcases to millions of consumers? Who will make diamonds immediately available via next day shipping to thousands of retailers across the world?

Is it worth sacrificing the diamond trade to maintain unsustainable artificial rough diamond prices? In fact, the mining companies cannot survive without the trade. You can't recreate a global diamond trade with hundreds of thousands of expert members all over the world. Without the trade, the mines are worthless. So why are the mining companies killing the trade? Are they unable to see the consequences of their actions?

One wonders how long the Botswana government and Gokhran, the Russian treasury, want to play monopoly with their diamonds and our lives. Botswana makes a good case for beneficiation — the idea that the people of Africa should benefit fairly from their diamond resources. I support and agree with this. But Botswana must understand that others also have rights to benefit from diamonds. What about the hundreds of thousands in India who have lost and are losing their jobs and livelihood. Have there been suicides in Botswana like there have been in India?

What about simple economics? If the trade goes bankrupt, the mining companies will go bankrupt. De Beers is not only starving the trade of profits, they have begun to starve the people of Botswana of revenue by halting their rough purchases and payments. We expect De Beers 2H 2015 sales to plummet by at least 60 percent or more to about \$1 billion versus \$2.987 billion of last year. Ponzi bubbles are not good for anyone, even those that create them.

So how do we change the position of the mining companies? What must we do? We have to communicate to the CEOs of De Beers and Anglo American that just because you can take advantage of the trade does not mean that you should. Destroying long-term client trust relationships — the essence of the De Beers brand — while bankrupting the diamond trade for the sake of short-term balance sheet profits is poor leadership at its worst. Frankly, De Beers CEO, Philippe Mellier's brand of trade exploitation and cannibalization is no longer tolerable. It is time for Mellier to go. If De Beers wants to survive in the diamond distribution business they must urgently appoint a leader who is a diamantaire, someone who is knowledgeable and passionate about the diamond business and the future of the diamond trade.

Now that you have read this article it's time for you to communicate. Let Mark Cutifani, [mcutifani@angloamerican.com](mailto:mcutifani@angloamerican.com), the chairman of Anglo American, know your concerns about profitability in the diamond trade. You can also email me at [martin@diamonds.net](mailto:martin@diamonds.net) with your views and a copy of your email to Cutifani. Our Facebook group "Diamond Forum" and tweet #diamondprofits are also available for your comments. ♦

“Is it worth sacrificing the diamond trade to maintain unsustainable artificially high rough diamond prices?”

*For more background information reference "Market Correction," by Martin Rapaport, Rapaport Magazine, May 2015 or <http://bit.ly/1XlZThJ>*

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*We wish all of our readers a successful and profitable holiday season.*