PRECIOUS STONES

Mixed picture for diamonds

Production is down, sales volumes are up, and rough prices are looking better

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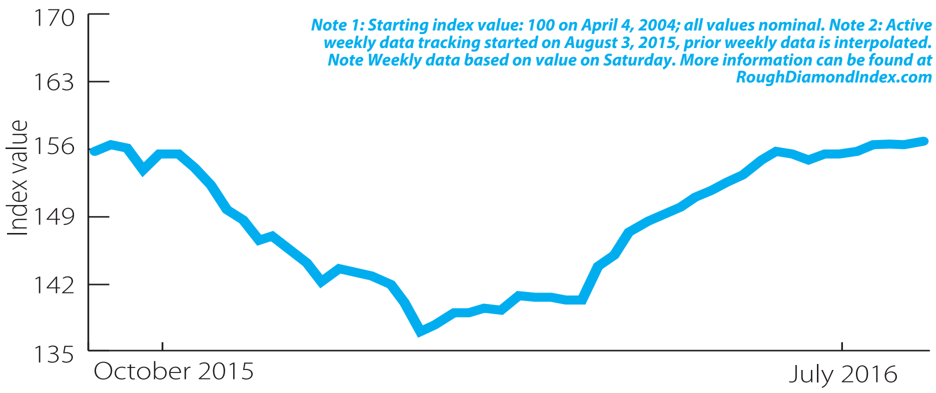

One year/52 weeks. Last value 156.53. One year change: 0.41%, as of August 27, 2016. Low on January 23, 2016. High on August 27, 2016

The global economy performed better than most expected in the first half of 2016, as the world's largest diamond jewellery market, the US, held back on further rate hikes, and policy in China, the world's fastest-growing diamond jewellery market, promoted credit creation.

The US Federal Reserve Bank has been more dovish in 2016 after raising the Fed funds rate last December, for the first time in nine years, which fuelled the S&P 500 to a new all-time high in early June, after marking a multi-year low in February.

China responded positively to government stimulated credit support, which stabilised what had been a volatile 2015 for Chinese property and financial markets. China's most economically advanced regions, driven by service sectors, such as Shanghai and Beijing, have showed the most improvement, but the less-developed, industrial-driven regions, primarily in the northern portions of the country, continued a lagging growth trend that first became apparent last year.

In late June, the UK referendum to leave the EU passed, which has since sent the pound down 11% against the dollar, and led to the Bank of England cutting rates in August for the first time in seven years.

In the US and China, in particular, service sector growth has outpaced manufacturing, which typically suits consumer demand for luxury discretionary commodities like diamonds, more so than industrial/construction commodities, such as base metals and energy.

This trend matched De Beers' parent Anglo American's most recent operational update released late July, which showed that in the first half of 2016, diamonds made up 42.3% of Anglo's EBIT (earnings before interest and tax), versus 30.6% over the same period last year.

Over the last year or so, Anglo has been working to gear its business strategy to prioritise the diamond business, while divesting assets, such as iron ore, nickel, and coal, and using the proceeds to pay back debt. Anglo's stock has rallied almost 290% from a low in January, and is now just off its 52-week high.

De Beers' production volume in the first half of this year was down 14.8%, year-on-year, consistent with the industry's strategy to curtail diamond supply to the market in an effort to mop up excess stock in the mid-stream and downstream segments of the industry chain.

However, De Beers' sales volume was up 29.2% through the end of June, a demand figure that shows the supply strategy is working and that the industry's excess inventory levels have been diminished.

One of the company's most recent sales, ending the week of July 29, (not included in first half results), showed a 160% increase in diamond value sold over the same sale last year (US$520 million compared to some $200 million), which is especially noteworthy given the seasonally subdued nature of diamond demand this time of year.

The market's response to the sales was underwhelming, and the industry sentiment at the moment is more pessimistic than justified, as many expect demand to tail-off a little going into year-end, despite data remaining optimistic.

De Beers' average price per carat sold in the first half of 2016 was $190/ct, down 16.2% versus the same period last year. This compares to a 13.1% decrease in the broader Zimnisky Global Rough Diamond Price Index over the equivalent period of time.

The relative weaker figure achieved by De Beers is most likely a result of a lower-quality product mix sold, mostly attributable to a 17.1% and a 69.5% decrease in Namibia and Canada production, respectively, the company's two highest-diamond-quality producing divisions, by average price-per-carat.

Namibian production was impacted by one of the division's offshore mining vessels undergoing an extended period of planned in-port maintenance, and Canadian production was most significantly impacted by the non-profitable Snap Lake mine being put on care-and-maintenance in December of last year.

Russia-based Alrosa's production decreased 6% in the first half of 2016 over the same period last year, but the company's sales volume increased 20.6% in the period, consistent with the directional trends in De Beers' figures. Alrosa's average price per carat sold in the period decreased 2.3% to $115/ct.

Petra Diamond's production increased 30.7% in the first half of 2016, mostly attributable to the acquisition of a South African tailings operation from De Beers in January.

Without the acquisition factored in, Petra's company-wide production still rose 2.8% in the first half of the year against the same period last year. Petra's sales volume increased 21.5%, and the average price per carat sold by the company increased 8.5% to $129/ct, mostly attributable to a higher-quality production mix sold. Petra is a relatively small operator and is only about a 10th the size of De Beers and Alrosa on a revenue basis.

According to the Zimnisky Global Rough Diamond Price Index, rough diamond prices hit a one-year high in the last week in August and are up 0.4% over the past year, 11.2% over the past six months, 2.5% over the past three months, and 0.6% over the past month. ■

First half 2016 diamond production comparables

	De Beers	Alrosa	Petra
Global market share (by value produced/%)	40.7	34.7	3.8
H1 2016 production (Mcts)	13.3	16.9	2.1
Year-on-year change (%)	-14.8	-6.0	30.7
Sales volume (Mct)	17.2	21.7	2.1
Year-on-year change (%)	29.2	20.6	21.5
Average PPC sold ($)	190	115	129
Year-on-year change (%)	-16.2	-2.3	8.5
Price performance relative to Zimnisky Index (%)	-3.1	10.8	21.6

Notes: 1) Market share based on company's estimated value of diamond production in 2016 relative to estimated global diamond production value of $12.6 billion. 2) Year-on-year change is based on H1 2016 versus H1 2015. 3) Figures represent difference between change in average price per carat sold by company in H1 2016 versus H1 2015, and change in Zimnisky Global Rough Diamond Price Index over the same time period, which is available at www.roughdiamondindex.com. All figures are based on company data and Paul Zimnisky estimates and analysis.