DIAMONDS

Searching for clarity

Supply and demand being pulled in different directions

Paul Zimnisky*

Photo: DPA

Gahcho Kué (pictured) and Renard, in Canada, have both got off to a disappointing start

After a very strong recovery following an industry-wide inventory buildup in 2014-2015 and again after India's demonetisation in late-2016, the diamond industry's momentum has begun to stall, or perhaps normalise is the proper verbiage.

Here we are, a little more than half way through 2017, and industry fundamentals are not necessarily negative, but signals are mixed with a subdued tone.

In the industry's largest market, the US, retail diamond jewellery demand is somewhat underwhelming as large national retailers have underperformed so far this year despite a resilient economy and a stock market regularly hitting daily highs. In China – the industry's second-largest market – demand is improving, but the market is not thriving.

Rough prices are higher this year, but polished is flat, if not down in some categories, and there are indications excess polished inventory is building.

De Beers appears to be attempting to curtail excess supply to the market by continuing to raise rough prices while reducing allocations to clients, as Russian-major Alrosa is increasing production and supply to clients due to "strong demand".

Demand

US proxy Signet Jewellers: US end-market demand has been stable at best, with the largest player in the market underperforming as of late. In late May, Signet Jewelers announced an 8.2% year-on-year decline in same-store sales and a 25% decrease in earnings for the three months ending April 30, after adjusting for the calendar impact of Mother's Day. At the same time, the company said it will be selling its US$2 billion customer credit account receivables portfolio, a component that has been concerning to analysts and investors for some time.

While most of the underperformance has been attributed to a secular decline in US shopping mall traffic, part can be attributed to operational performance, and the latter has been recently addressed with store closures, a renewed focus on web sales, and the company naming a new CEO on July 17.

Chinese proxy Chow Tai Fook: In China, market leader Chow Tai Fook is showing encouraging signs. In the three months ended June 30, same-store sales were up 11%, year-on-year, in mainland China and up 5% in the Hong Kong/Macau market. The figures represent three consecutive quarters of same-store sales growth in the former and two in the latter.

Part of the growth can be attributed to Chinese consumers purchasing more jewellery at home versus abroad. Early last year, the Chinese government took steps to encourage more domestic luxury spending within its borders, which is showing signs of playing out. This development has consequently impacted revenues of downstream participants overseas that have generated a significant portion of revenue from Chinese tourists in recent years.

The company's results can also be explained by lower comparables relative to last year. The greater Chinese market, which includes mainland China, Hong Kong, Macau and Taiwan, has been volatile in recent years as it transitions from hyper-growth in the early 2000s. The transition can be seen by the deceleration in the rate of new store openings (*see graph*).

Marketing: Given the generational change in consumer preferences for luxury items like diamonds, the upstream segment of the industry came together to create the Diamond Producers Association (DPA) in 2015 with an aim of re-establishing generic diamond marketing. In June, the DPA upped its annual 2017 budget to US$57 million from just a fraction of that in 2016, with the majority directed towards US consumers.

Recently, De Beers said its 2017 marketing budget would be approximately $140 million, including its contribution to the DPA. Since De Beers contribution to the DPA is estimated to be about US$20-25 million, the market leader is planning on spending well over US$100 million on marketing its De Beers Diamond Jewellers stores and its Forevermark brand. This compares to the circa-US$200 million De Beers used to spend annually on its 'A Diamond is Forever' campaign.

Industrial: Industrial diamonds – which represent approximately 20-30% of natural diamond production by volume, but under 10% by value – have increased in price from an average of US$6 per carat in the December quarter of 2016 to US$8.50/ct in the June quarter of 2017, according to Alrosa.

In July, De Beers said it saw a modest upturn in demand for industrial diamonds from the oil and gas industry relative to the first half of 2016, but weaker demand for diamond abrasives used in road and mining applications.

Supply

The producers: Through June, De Beers sold US$2.9 billion of diamonds, which is a 3.6% decrease year-on-year, but 16.8% more than the 2015 equivalent. Alrosa has sold US$2.5 billion, down 0.4% versus last year, but up 14.8% on 2015. De Beers and Alrosa currently represent an estimated 39% and 28% of global diamond production by value and 22% and 26% by volume, respectively.

For the producers, the first half of 2017 has been marked by a notable return in demand for lower-quality rough diamonds severely impacted after the Indian government demonetised its highest denomination bank notes last November. On an investor call in May, Alrosa said: "The monetary reform did not hit [the Indian manufacturers] as hard as expected, so in the last few months they bought everything they [could]."

Producers have been unloading excess inventory consisting of primarily lower-quality goods and have seen their average-price-per-carat figures fall so far this year, despite raising prices on a like-for-like basis.

For example, De Beers has seen over a 20% decrease in average price per carat sold in the first half of 2017, over the first half of 2016, but has alluded to a 2-4% increase in its "average price index" over the timeframe.

De Beers Canada and BHP have previously worked on Peregrine Diamonds' Chidliak project

The Zimnisky Global Rough Diamond Price Index, which attempts to consolidate global rough diamond price data, is up approximately 5% year-to-date.

This year marks the first full-year of commercial production for two new world-class Canadian mines. However, Gahcho Kué, estimated to produce 4.2 million carats worth in excess of US$500 million this year, and Renard, estimated to produce 1.7Mct worth in excess of US$200 million, both got off to a disappointing start.

The mines are recovering fewer large stones than anticipated. In addition, the level of florescence of the diamonds produced at Gahcho Kué is restraining prices, and there has been a problem breaking diamonds during processing at Renard.

In the case of Gahcho Kué, the underperformance has left 49% owner, Mountain Province Diamonds, unable to fund a cash-reserve account required by its lenders. In May, the company received a waiver, but further flexibility may be needed.

The stock prices of Mountain Province and Stornoway Diamonds, the sole owner and operator of Renard, have consequently taken a hit. However, in the second half of the year, both producer's stocks could benefit as richer ore is accessed at Gahcho Kué's 5034 pipe, and remedies at Renard to address the breakage problem bear fruit.

Manufacturers have noted a preference for Renard goods over those from Gahcho Kué given the relative higher clarity and lower fluorescence.

The second-half of 2017 could also benefit Lucara Diamond, as the company returns to mining the South-lobe of its 100%-owned Karowe mine in Botswana. Heavy rains, integration of a new mining contractor, and processing plant upgrades have previously put mining of the South-lobe on hold, which is the portion of Karowe's AK06 kimberlite body from which the 1,111ct Lesedi La Rona was recovered.

Petra Diamonds, the London-listed producer with a portfolio of five ex-De Beers mines, did not deliver on production guidance in the second half of its fiscal year ending June 30. In addition, the risk associated with the company has risen in recent months as political concerns in South Africa and Tanzania, the company's two operating jurisdictions, escalate.

Petra's stock is down 32.9% year-to-date, however the company recently attempted to assuage concerns by reminding investors that production is still set to ramp-up in coming months and the potential of breaking lender covenants should "not present an issue".

On July 17, Canada-focused producer Dominion Diamond reached an agreement to be acquired by a relatively unlikely suitor, the Washington Companies. Privately-held Washington is based in the US and holds a multi-billion-dollar portfolio of businesses primarily geared towards natural resource production and transportation. Dominion will be Washington's first foray into the diamond industry.

With Dominion's stock never recovering from the 2007-2009 downturn, in late-2015 increasingly impatient investors pressured the company to consider strategic alternatives. However, a year later the stock traded at even lower-lows, following a processing plant fire at the company's majority-owned Ekati mine. In March, Washington made a "conditional expression of interest" for the company, which eventually resulted in the formal bid made in July.

Washington is acquiring Dominion just as production at Ekati's rich Misery Main pipe is ramping up and demand is returning for lower-quality brown goods: the bulk of the pipe's production. However, after Misery Main production concludes in around 2020, planned expansion projects at Ekati are arguably marginal at best, and the company's only other mine, a 40% stake in Diavik, is approaching the end of its life.

Explorers and developers: Perhaps the most significant development on the supply side of the industry is the progression of the Luaxe project in Angola. Earlier this year, a concession agreement was reached making Angola's government-run mining entity, Endiama, and Alrosa the primary owners. According to Alrosa, the Luele kimberlite pipe on the Luaxe concession is the largest discovery in the past 60 years, with an assessed value of "over $35 billion" [sic].

The Luele pipe is only 20km away from the world-class Catoca mine, also owned by Endiama and Alrosa. Luele diamonds are said to be of similar quality to those of Catoca, which are worth about $100/ct, but the ore grade is said to be even better.

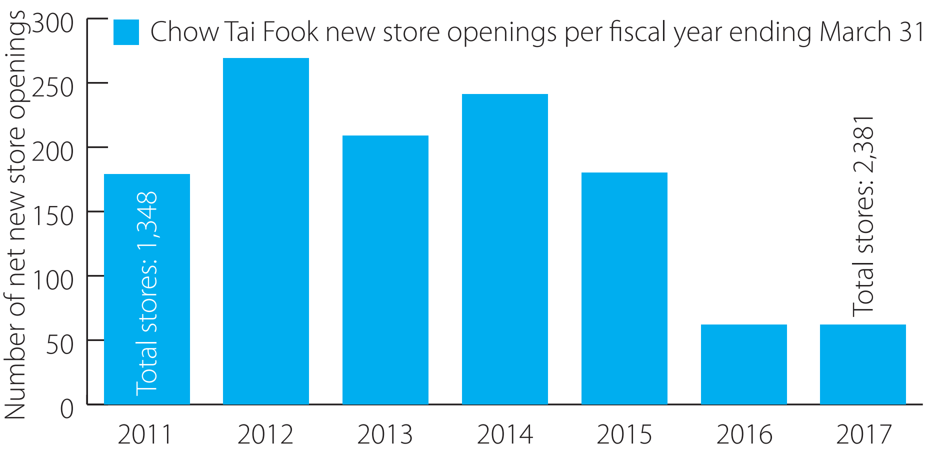
Construction of a standalone plant at Luaxe is still being considered, however initial production of Luele ore may commence as early as 2018 via trucking to the Catoca processing plant.

On the junior front, Mountain Province spin-off, Kennady Diamonds continues to progress its Faraday project after reporting in May that the company was in "discussions with certain interested parties regarding a potential strategic transaction".

The Faraday project could complement Kennady's further advanced Kelvin project, as both lie in close proximity to Gahcho Kué and, thus, have the potential to be expansion projects for Mountain Province and/or De Beers Canada. An independent diamond valuation of Faraday is due later this year.

In June, Shore Gold announced it had entered into an option agreement with Rio Tinto, where Rio could earn up to 60% of Shore's Star-Orion South project in Saskatchewan, Canada, over the next seven years.

Trading over C$7 (US$5.5) a share in 2007, Shore's stock has been down and sideways for almost 10 years, most recently trading at C$0.29, as the company's cumbersome diamond project has barely advanced. Star-Orion South is a world-class project in size but would require well-over US$1 billion to ▶



The rate of new store openings decreased 65% in the fiscal year ending March 31, 2016

Lipari Mineração is producing over 200,000ct annually at its Brauna mine in Bahia, Brazil

build, a substantial undertaking in a Canadian province that has never before seen commercial diamond mining.

Rio, with an US$80 billion market cap, is an ideal partner given not only its capacity to finance a mine build, but also its experience with Canadian diamonds (Rio is the 60% owner and operator of Diavik). Still, Rio can take its time as the first phase of the option does not expire for three-and-a-half years.

On an analyst call in early July, Peregrine Diamonds mentioned that the company had been in later-stage discussions with a strategic partner, but a deal was not finalised.

In the meantime, the company is moving forward with a C$10 million rights offering to fund further development of its 100%-owned Chidliak project in Nunavut, Canada. Peregrine was previously involved with majors BHP and De Beers Canada at Chidliak. The former parted ways in 2011 upon exiting the diamond business and the latter walked in 2013 as parent Anglo American cut its company-wide exploration budget.

North Arrow Minerals is also advancing a project in Nunavut, spending over C$3 million to carry out a mini bulk sample at its Naujaat project. In 2015, North Arrow recovered fancy yellow/orange diamonds sampling the project's Q1-4 kimberlite. A larger bulk sample and subsequent diamond valuation is anticipated for 2018.

London-listed Botswana Diamonds discovered a kimberlite in South Africa in close proximity to the former-producing Helam mine. The discovery will be further sampled to determine if the kimberlite is diamondiferous. Botswana Diamonds has an earn-in arrangement with privately-held Vutomi Mining to explore the area.

In Brazil, Toronto-listed explorer Five Star Diamonds is also carrying out a mini bulk sample at its Jaibaras project in the north-eastern region of the country. Eight kimberlites were identified at Jaibaras by De Beers in the 1990s and gem-quality macro diamonds have previously been recovered at two of the pipes.

There has been very little diamond activity in Brazil since De Beers and Rio left the country almost 15 years ago, however, privately-held Lipari Mineração is currently producing over 200,000ct annually at its Brauna mine in Bahia. There has never been a world-class diamond discovery in Brazil and, outside of Brauna, all previous production has been via alluvial mining. ■

All stock price and change figures as of July 25, 2017. At the time of writing, Paul Zimnisky held a long position in Lucara Diamond Corp, Stornoway Diamond Corp, Kennady Diamonds, and a covered-call position in Signet Jewelers. Paul Zimnisky is an independent diamond industry analyst and consultant and can be reached at paul@paulzimnisky.com and followed on Twitter @paulzimnisky