

DIAMONDS

Miners roll out dividends

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Diamond miners are finally showing their potential as four companies in the highly concentrated industry have all announced first-time dividend programmes over the past 12 months.

Despite a weaker diamond price in recent months due to tightened industry credit availability, a strong dollar and a slowing of growth in Chinese luxury consumption, diamond miners have remained profitable.

Over the past year, four out of five of the global universe of pure-play publicly traded diamond producers with market caps of at least US\$250 million were profitable; and all four have recently initiated first-ever dividend programmes.

Russia's Alrosa was the only unprofitable company of these producers due to a foreign exchange (FX) hit it took in 2014 on debt borrowed in US dollars. The loss of Rb64 trillion (US\$1.3 billion) came in the second half of the year as the rouble retreated to record lows versus the dollar.

The concurrent implementation of dividend programmes across the industry could be seen as a fundamental shift in the investability of diamond miners, an industry that some would say has a reputation of failing to generate shareholder value. The diamond mining business is notoriously challenging given the high execution risk and capital-intensive nature.

In recent years the industry has benefited from improved operating efficiencies, which has led to more consistent cash flow generation. Most of the companies in the space are relatively new operators, having only started production within the last decade in the years following De Beers'



Haul trucks at Gem Diamonds' Letšeng mine in Lesotho in April 2014

Photo: Gem Diamonds

restructuring. Experience gained by the new miners over that time has resulted in improved production and recovery techniques.

A stronger dollar has also benefited miners operating in Africa, Canada, and Russia, where labour and other operating costs paid in local currencies have become less expensive relative to the price of diamonds sold by the companies in US dollars.

While improved operating economics has provided the companies with the means necessary to return cash to shareholders, the advent of dividend programmes is impart due to a fundamental shift that has taken place in the mining industry as a whole – not just those producing diamonds – and geared more towards returning cash to investors than accumulating resource inventory.

In the second half of last decade, in the midst of the commodity "super-cycle", the global investment community encouraged mining executives

to accumulate and hoard reserves, even if through expensive acquisition, as investors valued mining companies on resources and reserves held in the ground, and not so much on production cash flow and profitability.

The global financial crisis rendered many of these expensively acquired reserves uneconomic, which led to record-setting writedowns in the mining industry over the past six years.

Global investors have since begun valuing mining companies using more traditional profitability metrics, putting pressure on executives to shift focus to production efficiencies and cash-flow generation.

In June 2014, Lucara Diamonds was the first stand-alone diamond miner to start a dividend programme, which yielded 1.7% at the time, or 3.5% including the "exceptional diamond" special dividend that was also paid.

Since then, Dominion Diamond, Gem Diamonds and

Petra Diamonds have all announced dividend programmes. Alrosa was paying a dividend prior to going public in October 2013, and continues to do so despite the FX loss realised in 2014.

De Beers, a subsidiary of larger diversified miner Anglo American, is not included in the universe of stand-alone diamond miners, however, De Beers' recent performance relative to Anglo's other divisions is consistent with the rest of the players in the space.

In calendar 2014, Anglo's company-wide EBIT (earnings before interest and tax) decreased 25.5% year-on-year, while De Beers' EBIT actually increased 39.5%. The De Beers unit represents 24.8% of Anglo's total assets.

Using the universe of standalone diamond miners as a market proxy, De Beers is valued at around \$7.3 billion. If Anglo were to spin out the division, it is not unreasonable to assume that the market would also pay a pure-play premium for the industry leader.

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