

DIAMONDS

Lucara results have deeper meaning

Timing of tender sets up trade for small-cap diamond miner

Paul Zimmisky

Weak diamond prices have hindered all miners as of late, but Toronto-listed Lucara Diamond's second-quarter results looked especially dismal at first glance as the company's average US\$/ct for the period fell a staggering 53.3% year-on-year and income concurrently dropped 44.9%.

However, after digging a little deeper, it is apparent that the timing of Lucara's first "exceptional" diamond tender of 2015 made the company's Q2 financial results appear worse than they actually were. The tender did not conclude until July 16, so its contribution was not included in the company's Q2 figures, which only included activity up to June 30.

The company's "exceptional" diamonds, those it estimates to sell for at least US\$1 million, make the Lucara's Karowe mine in central Botswana the source of world's second-most expensive diamonds on an average per-carat basis – a figure that tends to be skewed by the few, but extremely valuable, exceptional stones the mine produces. Lucara's exceptional diamonds represent less than 2% of the company's production by carat volume, but on average sell for more than 100 times the company's regular production.

On top of the timing effect the exceptional tender had on headline sales figures, the company also guided that milled ore would be about 6% lower than previously estimated for full-2015 due to temporary plant optimisation disruptions. Ore will still be mined at planned rates, but processing of the ore and recovery of diamonds will be affected. This



'Exceptional' diamonds make Karowe in Botswana the source of world's second most expensive diamonds on an average per-carat basis

will lower the recovery of diamonds available for sale by about 35,000ct, or about \$18.5 million in revenue, in the back-half of the year.

While actual production decreased by about 35,000ct in the first half of the year over the 2014 first half, diamond sales in 1H 2015 dropped less than proportionately as sales tend to lag production.

However, this lag will catch up and the

impact should be apparent in the second half of the year and early 2016.

In the first day of trading following the Q2 report, which was released after the close of trading on August 11, Lucara's stock sold off 8.8%, down to C\$1.76/share.

The stock has since traded down further to C\$1.53/share, or -20.7%, since the release, equivalent to a C\$152 million (US\$200 mil-

Lucara quarterly performance metrics

Quarter	Q2-15	Q1-15	Q4-14 ²	Q3-14 ¹	Q2-14
Diamond sales	\$39.7	\$29.7	\$70.5	\$66.5	\$95.0
Revenue	\$38.1	\$29.7	\$70.5	\$91.2	\$71.0
% Revenue from sales	104%	100%	100%	73%	134%
Carats sold	100,177	106,777	104,405	88,364	111,900
Average PPC	\$396	\$278	\$675	\$753	\$849
'Exceptional' tender held			*	*	*
Carats produced	85,714	90,077	113,950	106,162	99,142
% of carats produced sold	117%	119%	92%	83%	113%
Production cost per carat	\$160	\$108	\$89	\$122	\$132
Capex per carat (additional)	\$102	\$175	\$199	\$134	\$98
Net income (NI)	\$8.6	\$6.0	\$4.4	\$41.8	\$15.6
NI per share	\$0.023	\$0.016	\$0.012	\$0.110	\$0.041
P/E	12.4	10.0	11.9	10.3	17.0

In millions of US\$ except for per-carat and per-share figures

"PPC" is price per-carat. "PC" is per-carat. "T" is trailing 12 months

1) Difference in diamond sales and revenue figure primarily attributed to lag in sales proceeds, which impacts net income for the period

2) Figures adjusted for Mothae mine impairment charge of \$21.2 million. Without adjustment net income for the period was -\$16.8 million

Figures are based on company data and Paul Zimmisky estimates and analysis

Commodities

History of Lucara's 'exceptional' diamond tenders

Tender date	16/7/2015 ²	21/10/2015	16/7/014	10/4/2014	25/11/2013
'Exceptional' tender revenue	\$68.7	\$46.4	\$40.1	\$50.5	\$22.9
'Exceptional' tender carats sold	1,674	1,540	1,445	1,191	1,128
Average PPC of 'exceptional' tender	\$41,045	\$30,129	\$27,765	\$42,376	\$20,301
'Exp' tender rev to total rev for period	64%	66%	44%	71%	39%

In millions of US\$ except for per-carat and per-share figures

'PPC' is price per-carat. '% Total Rev' is the percentage of revenue that the 'exceptional' tender contributed to total revenue for the quarterly period

1) % of total revenue figure is based on Q2 2015 figures for comparative purposes even though tender was not included in those results. The July 16, 2015 tender results will be included in Lucara's upcoming Q3 2015 figures. Figures are based on company data and Paul Zimmisky estimates and analysis

Lucara Q2 2015 performance with/without July tender, compared to previous Q2

Quarter	W/ July Tender	As Reported	Q2-14
	Q2-15	Q2-15	
Diamond sales	\$108.4	\$39.7	\$95.0
Net income (M)	\$17.8	\$8.6	\$15.6
Carats sold	101,851	100,177	99,142
Average PPC	\$1,064	\$396	\$958
Net income (M) effect	107%		
Average PPC Effect	169%		
Per share effect (US\$)	\$0.024		

In millions of US\$ except for per-carat and per-share figures

"PPC" is price per-carat. "EPS" is earnings per-share

This comparison shows the impact that Lucara's July 16 'exception' diamond tender would have had on Q2 2015 financial results if it was included

Figures are based on company data and Paul Zimmisky estimates and analysis

lion) decrease in market cap. C\$1.53 marked a new 52-week-low for the shares, which traded as high as C\$2.45 in November of last year.

While the market responded negatively to the report, Q2-over-Q1 numbers actually look quite promising. The company's average price-per-carat increased 42.5% over the previous quarter, and income increased 43.3%.

The company attributed the increase to the recovery of higher-value diamonds, those not qualifying as exceptionals during the period.

The ongoing plant optimisation aimed at improving recovery played a role as a greater percentage of larger stones were recovered without damage.

Even more promising, the July 16 "exceptional" tender produced US\$68.7 million in sales, which if included in the Q2 numbers

would have further improved the average price-per-carat for the period 168.6% to US\$1,064/ct, and net income by some 107% to US\$17.8 million, equivalent to an increase of C2.4c/share of earnings.

Further, the July tender resulted in the second highest prices ever achieved for the company at an exceptional tender; an average price-per-carat of US\$41,045, second only to the US\$42,376/ct achieved in April 2014.

It is worth noting that the company increased the threshold for what qualifies as an exceptional diamond in 2015, a change in categorisation that should impact the average price-per-carat figure for exceptional diamond sales as well as regular sales, as some stones that in previous years would have been sold as exceptional are now sold at regular tenders.

That said, cumulative diamond sales for 2015, exceptional sales included, have yielded an average price-per-carat of US\$662, which is an increase of 2.8% over the US\$644 achieved in 2014.

The prices Lucara recently received for its production mix show how relatively well positioned the company is in an overall weak diamond market.

Global rough diamond prices on average are down 12.1% over the last 12 months, according to the Zimmisky Global Rough Diamond Price Index.

Dampened demand for diamonds in Asia, continued credit challenges in the industry, and a stronger dollar have led to a global glut of polished diamonds.

In some cases jewellery manufacturers can currently buy polished for less than they can buy and produce rough.

This negative spread has effectively wiped out some diamond cutter's margins, especially those primarily dealing with average-quality product.

However, higher-end rough, such as Lucara's exceptional diamonds, are much more limited in supply, and prices have held up significantly better than average-quality diamonds.

Manufacturers have shown that they are still willing to pay top dollar for the premium product needed to fulfil special high-end customer needs.

For example, in July, the highlights of Lucara's exceptional tender were the sale of a



Source: Yahoo!, notations Paul Zimmisky

Lucara two-year daily stock chart as of September 9

	2/9/2013	22/5/2013
	\$24.7	\$24.9
	1,028	816
	\$24,027	\$30,468
	59%	53%

342ct Type IIa white, and a 270ct white, which sold for US\$20.6 million and US\$16.5 million, respectively, which on a per-carat basis is in line with what the company has received for similar quality stones going back as far as 2013.

Since the July sale, Lucara has recovered five more exceptional stones, which will most likely be sold at a recently announced November tender in Gaborone.

A 336ct Type IIa white, 184ct, 94ct, and 86ct whites, and a 12ct faint-pink, were all recovered in a two-day period, August 15 and 16.

The pink is the first fancy coloured stone recovered from the mine's South Lobe, a higher grade section of Karowe's kimberlite

body that has recently become the company's target area of production.

While I typically advise against buying stocks that are making new lows, I like the prospect of a long Lucara trade going into Q3 (September quarter) results, especially at current levels.

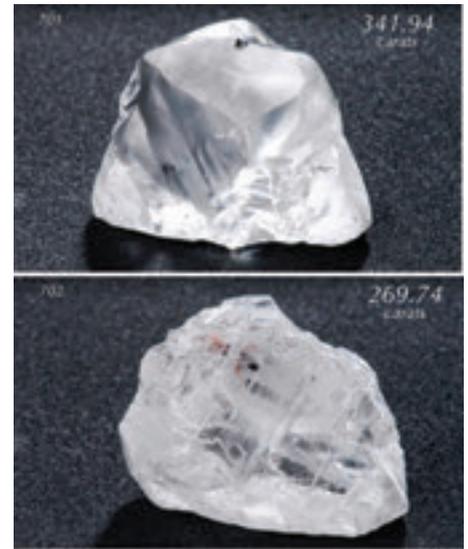
The headline quarterly figures will benefit from the July exceptional tender, and there is potential for more notable high-quality diamonds coming out of Karowe's South Lobe in the meantime.

With exceptional diamonds historically representing on average 57% of the company's total revenue, the company has remained profitable despite global diamond price weakness.

The C\$580 million market-cap company is currently trading at 9.6 times trailing earnings, and maintains a dividend programme, with a trailing yield of 5.2%.

In addition, the backdrop of a highly anticipated De Beers second-half 2015 marketing campaign should benefit the diamond industry as a whole and in turn support prices.

Lastly, mining equities in general appear to be bottoming out as they make multi-year



342ct 'exceptional' diamond (which sold for more than US\$20 million) and 270ct stone, which sold for more than \$16 million in Lucara's July 2015 tender

lows on record volume, which could result in some general rotation back into the space after multi-year long investor apathy. ▼

Paul Zimnisky is an independent diamond industry analyst and consultant in New York

BUILDING QUÉBEC'S FIRST DIAMOND MINE

TSX: SWY www.stornowaydiamonds.com