CUTTING AND POLISHING

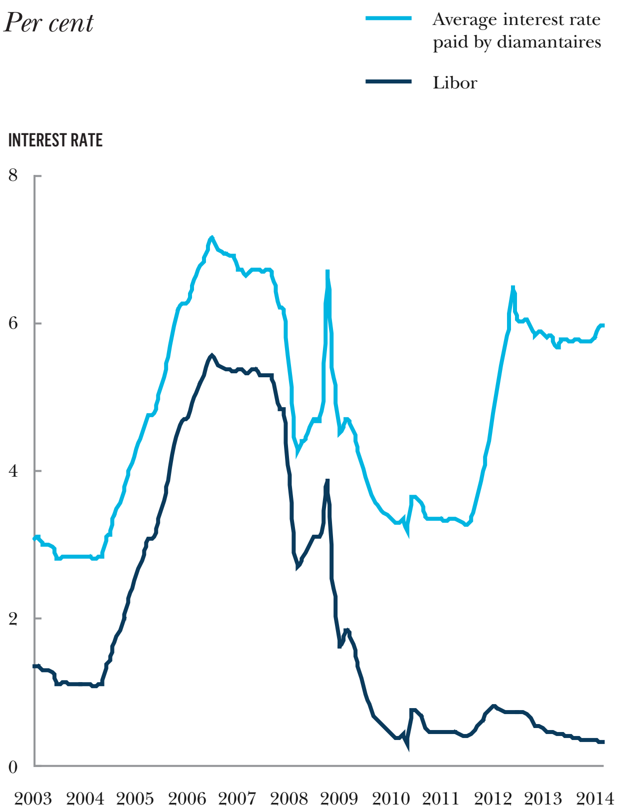
2013 SNAPSHOT

The cutting and polishing industry is global in nature. It remains fragmented, with thousands of companies operating with multiple business models, including wholesalers, rough dealers, manufacturers and polished dealers, as well as combinations of these activities. The Israel Diamond Exchange, for example, has more than 3,000 members[16], many of which are very small companies or sole proprietors. Even among the leading companies in the sector, there are many traditional family-owned businesses with a long history in the diamond industry.

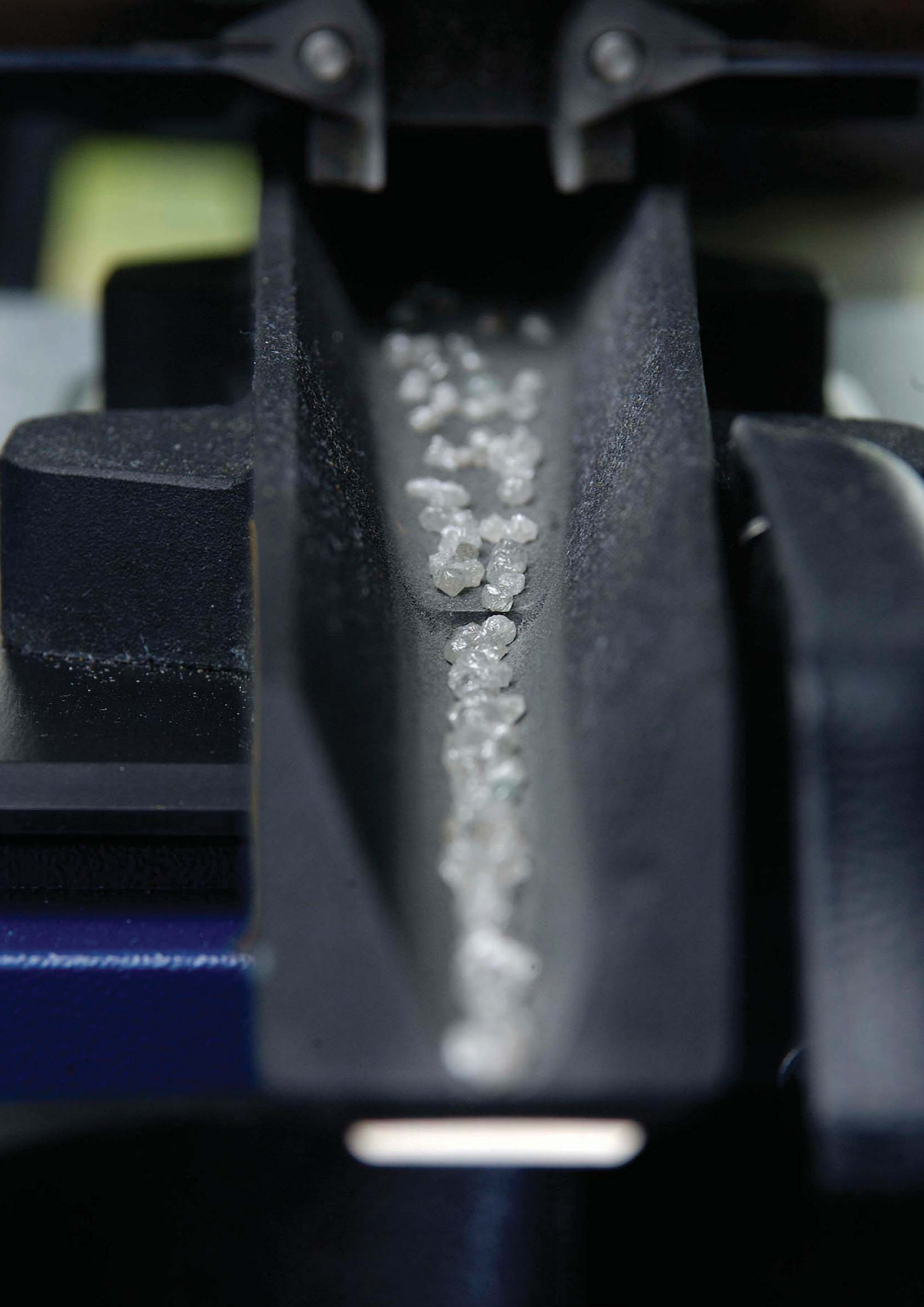
However, recent years have seen the midstream sector coming under increasing pressure for a number of reasons. These include lower carat supply, increasing costs in the upstream, and growing pressure from the retail sector, where consumers make higher demands and brands take greater share (as described in the 'Diamond Jewellery Retail' chapter of this report). These trends are compounded by significant financing challenges: as polished demand increases, the midstream needs additional funding. Declining overall central bank interest rates[17] have not resulted in lower borrowing costs for midstream companies, indicating that banks perceive increasing risks in the diamond sector overall (see Fig. 17).

FIG. 17: **DIAMANTAIRES' BORROWING COSTS OVER TIME VS LIBOR RATES**

Per cent



Source: De Beers estimates; ICE Benchmark Administration Limited (IBA) for Libor rates



An interview with Erik A. Jens, CEO, ABN AMRO International Diamond & Jewellery Clients

A DIAMOND INDUSTRY BANKER'S VIEW ON MIDSTREAM ISSUES AND SOLUTIONS

Q CAN YOU BRIEFLY INTRODUCE YOURSELF AND YOUR EXPERIENCE WITH THE DIAMOND INDUSTRY?

I joined ABN AMRO International Diamond & Jewellery Clients, one of the major lenders to the midstream over the last century, as the CEO more than two years ago. My background is in private banking and finance, particularly hedge funds, so I entered the diamond industry with a fresh perspective.

Q HOW HAVE YOU SEEN THE MIDSTREAM EVOLVE SINCE YOU FIRST STARTED WORKING HERE?

I have seen the industry's attitude to change evolve. A couple of years ago, the midstream had a large culture of blame: blaming miners for high prices, retailers for stealing margins and bankers for limited support. Recently, however, midstream players have looked at themselves in the mirror, and become self-critical in their practices. There appears to be a readiness to embrace change from within, in order to tackle the increasingly competitive landscape. I believe this is a positive thing because it means the industry is becoming more transparent and sustainable.

LOOKING AHEAD

PRESSURE ON THE MIDSTREAM IS LIKELY TO LEAD TO PROFESSIONALISATION AND CONSOLIDATION

Financing challenges are increasingly critical and could intensify over the coming years. Rising inventory costs, and diamond banks' drive to constrain the growth of their lending to the midstream, will mean financing costs are unlikely to decrease, particularly if the trend of low interest rates begins to change.

Additional financial scrutiny of the midstream sector can therefore be expected. Leading banks in the diamond sector have come to realise that they have been taking equity-type risks in the diamond midstream without getting the corresponding returns. This is now changing and, as a result, borrowing costs are going up while banks are asking their borrowers to professionalise their capital management.

Overall, this trend is expected to affect the way the industry operates. New lending standards will increase the regulatory burden on the midstream, leading to higher costs and operational complexity. One possible consequence is that less well-established companies may even exit the industry, leading to some level of consolidation.

Over time, those firms that are able to add significant value in the diamond cutting and polishing process are more likely to be successful.

To succeed in today's highly competitive midstream, diamond businesses must develop strongly differentiated, value-added propositions that set them apart from their competition. Diamantaires at all stages of the value chain have approached this challenge in their own unique ways. Rough dealers and preparers, such as Dianco, Diarough, De Toledo and Fruchter Gad, have developed their own unique, proprietary and bespoke assortments which are carefully targeted and adapted to the needs of specialist manufacturers.

Rough polishing has been the source of tremendous innovation over the past decade, with Indian firms such as K Girdharlal, Venus, Karp and Kiran leading the way: their implementation of advanced IT and laser technology has revolutionised the precision and yield recovery of the cutting and polishing process.

For other firms, polished diamond distribution has become the key to their differentiation. Sophisticated internet-enabled stock management systems allow businesses such as EZ Diamonds, YDI and Star Rays to respond with speed and precision to their customers' changing needs, often integrating seamlessly with a customer's own order management systems.

WHAT ARE YOUR KEY CONCERNS REGARDING THE FINANCIAL HEALTH OF THE MIDSTREAM?

There is general lack of transparency in business practices and quality of reported financials across the midstream, leading to a loss of trust. This is compounded by the fact that the midstream is highly levered. Banks are therefore being more critical and thorough with funding decisions, and looking for a greater level of security against their loans.

HOW DO YOU THINK THE MIDSTREAM CAN ADDRESS THESE CONCERNS FOR THE FUTURE? WHO HAS BETTER ACCESS TO FUNDING AND WHY?

When approaching financing decisions, we assess the 'bankability' of the clients – whether their business is in good financial health with transparent business plans, if they apply IFRS or equivalent GAAP standards especially when reporting receivables and inventory, and streamlining processes such as the removal of inventory round-tripping. Financiers reward sound fiscal management and good compliance by providing better lending conditions and more favourable rates. I also believe in openness between banks and their clients in order to work through any issues – which in the end comes back to the importance of transparency.

WHICH DO YOU BELIEVE ARE THE MOST SUCCESSFUL PLAYERS IN THIS INDUSTRY AND WHAT ARE THEY DOING THAT IS MAKING THEM SUCCESSFUL?

In an increasingly competitive landscape, competitors have to adopt strategies to ensure survival and sustainability. Sustainability, in my opinion, is the right to exist. This is achieved by being prepared to compete in a saturated space with dynamic and flexible business plans, investment in infrastructure and technology and diversification. Some successful players have shown innovative manufacturing and cutting strategies to produce greater yields as well as developing a unique product.

DO YOU EXPECT CONSOLIDATION GOING FORWARD?

The rate of change is still very slow, so I do not envisage much consolidation in the next five years or so. However, I do see the competitive landscape getting tougher, which will lead to those less sustainable businesses disappearing.

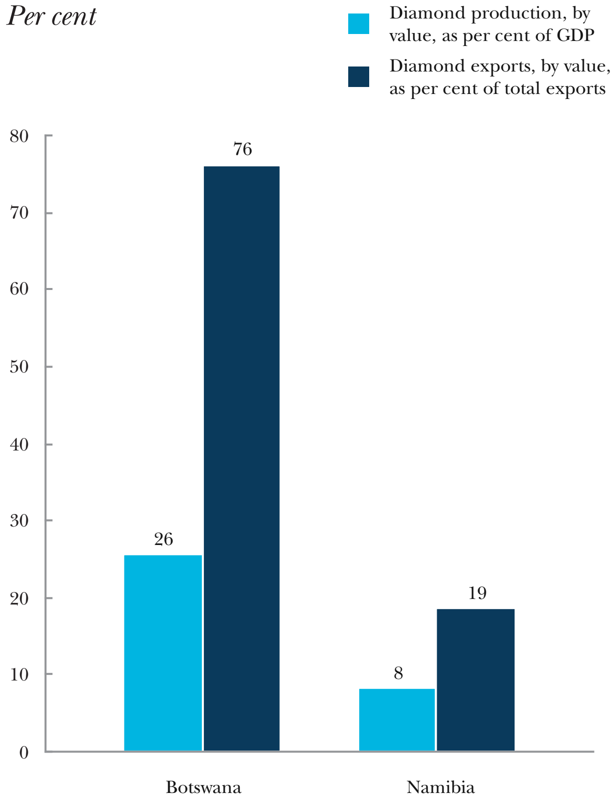
Many midstream companies now also offer a consumer branded proposition that creates a unique identity around the precision cuts they manufacture. These include Leo Schachter with the Leo cut, Exelco with Tolkowsky and Crossworks with the Ideal Square and Ideal Cushion.

THERE WILL BE A CONTINUED PUSH FOR IN-COUNTRY BENEFICIATION

When it comes to the geographical location of cutting and polishing, the move towards low-cost centres in India and the Far East is likely to have reached its peak. Over recent years, producing countries such as Botswana, South Africa and Namibia have been striving for increased domestic beneficiation, leading to some cutting and polishing jobs migrating to those countries.

Diamonds are critical to the economies of some producing nations. In Botswana, for example, diamonds represent more than one quarter of GDP[18] and over three-quarters of overall exports[19], whereas in Namibia they represent eight per cent of GDP[20], and almost 20 per cent of exports[21] (see Fig. 18). However, diamond mining in itself only creates a limited number of jobs (as is also the case with other types of mining) since it is capital-intensive rather than labour-intensive.

FIG. 18: DIAMONDS' SHARE OF GDP IN KEY PRODUCING COUNTRIES IN 2013



Source: The World Bank; Kimberley Process Statistics; De Beers analysis

FIG. 19: CONSENSUS VIEW OF CUTTING AND POLISHING COSTS AND EMPLOYMENT IN CUTTING CENTRES

CUTTING CENTRE	APPROXIMATE CUTTING AND POLISHING COST USD/CARAT [i] 2008	2013	APPROXIMATE TOTAL CUTTING AND POLISHING JOBS 2008	2013	
Canada	125	140 NWT 180 Ontario	300	50-80	
Botswana	45->125	60-120	2,200	3,750	Producer countries are gaining share on the back of government policy, despite higher costs than traditional manufacturing locations
Namibia	45->125	60-140	1,500	970	
Belgium	120	150+	1,000	150-200	'Old' cutting locations have lost share of manufacturing following migration first to low-cost locations and subsequently to producer countries
US	110	300	100	80-100	
South Africa	60-100	130-150	1,800	1,000	
Israel	47->55	140->300	2,000	400	
Far East	15-35	20-50	29,000	10,000	The trend of growth in low-cost locations has recently started to reverse
India	6-50	10-50	850,000	800,000	

i These are estimates for the majority of production units and exclude outliers

Source: De Beers estimates

This is one of the main reasons why the governments of southern African countries, for example, have been keen to ensure their countries expand along the value chain to sectors that create more jobs, such as cutting and polishing.

At the same time as creating local jobs, beneficiation policies create a challenge. Lower worker productivity means that cutting costs are higher in southern Africa than in countries such as India, and so the move towards local cutting increases costs and reduces the profit pool that can be shared between producers and governments (see Fig. 19).

In order for local beneficiation to be sustainable in the long term, producing countries will need to make an effort to develop competitive downstream industries that can create value as well as generate jobs.

This will require investment in skills development and infrastructure as well as thoughtful regulation. Only in this way can the downstream diamond industry ensure long-term job creation that will attract investors and developers to the sector.