EXECUTIVE SUMMARY

This report aims to provide an annual perspective on the global diamond industry, drawing on The De Beers Group of Companies' extensive proprietary data and insight as well as other industry sources.

The report is divided into three sections: Section 1 provides an outlook for the global diamond industry; Section 2 describes the 2013 performance and key trends to watch in each part of the diamond industry value chain; and Section 3 highlights three 'In Focus' areas of particular importance to the industry. This year's report focuses on the changing consumer preferences in the world's largest and fastest-growing diamond jewellery markets, the US and China; on how technology is helping to safeguard the industry; and on the miracle of production, showcasing challenges and innovation in rough diamond mining.

SECTION 1: DIAMOND INDUSTRY OUTLOOK

In contrast with precious metals and other natural resources industries, which rely on multiple sources of demand, the diamond industry derives practically all its value from consumers' demand for diamond jewellery. The outlook for the industry is thus intrinsically linked to consumer demand. Even under scenarios of volatile or weaker global economic growth, demand for diamonds is expected to show positive real growth in the next decade.

Positive demand growth for diamonds will almost certainly outstrip growth in carat production, given the lack of major new discoveries in the last decade and the projected slowdown in several existing mines. Across the value chain, companies that are able to innovate and differentiate themselves will be best positioned to capture the opportunities created by this supply demand dynamic.

Relentless focus on two main areas will help the industry to achieve its full growth potential over the coming years:

- The first is **safeguarding and nurturing the diamond dream** – that is, the allure that diamonds have for consumers, based on their association with romance and a sense of the eternal, and the fact that they are seen as a lasting source of value. As always, changing consumer preferences, competition from other luxury categories, and – among other risks – the potential confusion caused by undisclosed synthetics all pose challenges for the entire industry.
- The second is for companies across the whole value chain to **innovate and differentiate**, to take full advantage of opportunities created by the expected growth in demand.

With these priorities in mind, three areas of investment are likely to be particularly important:

1. Investment in **branding, marketing and raised retail standards** will help ensure that consumers, particularly among new generations and new markets, do not drift away from the diamond jewellery category in favour of competing categories, such as travel, coloured stones, electronic accessories or designer fashion.
2. Investment in **production** to drive innovation and productivity in diamond supply. Diamonds have always been a rare and precious resource, and as mining moves deeper into the earth and towards more remote locations, the extraction process is now becoming increasingly complex, remote and more costly.
3. Investment in **technology** will continue to be a key differentiator across the value chain, while also safeguarding consumers against the risk of undisclosed treatments and synthetics, which could undermine the long-term credibility of the industry.

Lack of investment in these areas could hamper growth for the industry as a whole.

The industry's overall supply and demand dynamics should generate value-creating business opportunities that will enable such investments. However, scale and differentiation will be increasingly important factors for future success, across all parts of the value chain. The industry is likely to continue to consolidate and integrate (including through vertical integration). It is also expected to continue professionalising, modernising and becoming more transparent in the years to come – to the benefit of all those involved with this precious resource, from the geologist seeking the next big find to the bride wearing her diamond wedding ring.

SECTION 2: THE DIAMOND INDUSTRY VALUE CHAIN

Consumer demand for diamonds has shown positive nominal US dollar (USD) growth in the last five years, with compound annual growth in diamond value just under five per cent from 2008 to 2013. In this period, growth was driven mainly by the emerging economies of China and India, as well as the US, since 2010, while Japan and the main European markets have shown below average growth trends in this period.

The **diamond jewellery retail** sector is highly fragmented worldwide with a variety of business models serving a wide range of target consumers. The sector has experienced a range of financial returns. In developed markets, many jewellery retailers are failing to cover their cost of capital, resulting in negative returns and the closure of chains as well as smaller jewellers.

The recent acquisition of jewellery chain Zale Corporation by Signet Jewelers, another jewellery chain, illustrates the potential for consolidation in the jewellery retail sector.

Overall, retailers in emerging economies have outperformed their peers in developed economies, partly because of the recent fast growth of the middle classes and partly because of the rapid pace of store openings to supply growing demand in new geographies.

The online channel is becoming increasingly important around the globe, although consumers are going online for different reasons in different countries. In the US, the internet is becoming important as a sales channel in its own right: more than one-tenth of diamond jewellery sales in the US were made online in 2013. While online is not yet a significant sales channel in China, the internet is used by a quarter of acquirers for research purposes before purchase.

Many specialist fine jewellery retailers such as Tiffany, Cartier, De Beers Diamond Jewellers and Chopard continue to invest in product offers and store modernisation to support the diamond dream. Another major trend to watch is increasing activity by global luxury fashion houses such as Dior and Chanel in the sale of diamond jewellery. These global brands also support the diamond dream, and are raising consumer expectations of the store environment, in new design generation and customer service.

Branded diamonds and branded diamond jewellery present a growth opportunity for diamond jewellery retailers in both developed and emerging economies. Consumers worldwide increasingly prefer branded products and services. Brands can also be an attractive financial proposition for retailers because the brand identity frequently offers differentiation from generic propositions. The additional revenue that can be generated from brands should make it possible for retailers to invest in their store environment and in promoting their businesses and the category, leading to a virtuous circle of growth.

Cutting and polishing remains fragmented, with midstream companies under pressure from a combination of increasing costs in the upstream, the availability of credit and price-point requirements from their retail customers. The financing challenges are increasingly critical and could intensify over the coming years, as banks apply more stringent lending standards to the cutting and polishing industry. One possible consequence is that some companies may exit the industry, leading to greater consolidation. Over time, those firms able to add significant value to the diamond cutting and polishing process, and those with transparent corporate and financial structures, are more likely to be successful.

The shift of cutting and polishing operations 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. However, the development of a long-term sustainable cutting and polishing industry will require not only government intervention but also internationally competitive productivity levels.

Rough diamond sales and distribution channels are continuing to evolve, as producers experiment with sales methods to maximise the value of their rough diamonds. Over the last five years, auctions have grown in importance and it is possible that, as technology continues to evolve, this trend will continue. However, the major rough diamond producers are expected to continue to rely predominantly on long-term contracts to sell their production.

Producing countries have been playing a more important role in the sale and distribution of rough diamonds. This is driven by national governments' desire to increase their share of value from the primary resource. The continuing trend towards in-country beneficiation of diamonds saw perhaps its largest milestone yet in 2013, with the move of De Beers' Global Sightholder Sales to Botswana, and the organisation of De Beers' first ever international 'Sight' in Gaborone in November 2013.

Rough diamond production was an estimated 146 million carats in 2013, well below the 2005 peak of over 176 million carats mined[1]. Overall diamond supply is expected to increase moderately in the next few years, driven by new projects coming on-stream. By 2020, when many existing mines will begin to see declining outputs, overall supply will be likely to plateau and, unless major new discoveries are made in the coming years, supply can be expected to decline gradually from 2020.

Diamond production is becoming increasingly challenging as mining moves towards deeper, less profitable and more remote sources of diamonds. This trend is explored further in the 'In Focus' chapter, 'The miracle of production'.

Exploration spend is expected to remain high as the chase to find the next major source of diamonds intensifies. Today, most of the diamond exploration spend takes place in historically underexplored African countries such as Angola, the Democratic Republic of Congo (DRC) and Zimbabwe, as well as the vast swathes of Arctic Siberia and Canada. Large-scale profitable discoveries will most likely remain elusive, however. Viable diamond deposits of any scale are rare and difficult to find, and no amount of investment in exploration guarantees the discovery of deposits on which sustainable mining operations can be built.

In reality, exploration spend for diamonds has not kept pace with that for other natural resources; it is now at practically half the record levels seen in 2007, when the industry was spending almost US$1 billion per year on diamond exploration. This situation is not expected to change in the near future, as the global mining industry overall continues to face pressure on capital expenditure.

SECTION 3: IN FOCUS

'Changing consumer preferences and the growth of brands' looks in detail at how the consumer landscape is changing in the US and China. Notwithstanding the market's vertiginous growth over the last five years, China still offers a tremendous growth opportunity for the industry. Penetration of diamond jewellery is still relatively low and consumers' desire for diamonds is high. The situation in the US, a more mature market for diamonds, is different. Fine jewellery has grown more slowly than other luxury categories in recent years. However, there are promising growth areas in the US too, not least in bridal jewellery and branded diamonds and diamond jewellery, which have performed particularly well in recent years.

'Safeguarding the industry through technology' describes the vital role played by technology across the entire diamond value chain. Geologists rely on technological innovation to help them discover new, viable sources of diamonds in locations that are often hard to access and difficult to work in, such as the Arctic Circle. Mining companies also look to technological innovation to keep operating costs as low as possible. Rough diamond producers are dependent on automated high-speed technology to sort diamonds. Laboratories and cutting centres rely on detection equipment to identify undisclosed synthetics and treatments, which pose a challenge to consumers' confidence in diamonds.

'The miracle of production' explores the increasing complexity and cost of mining diamonds. This section explains what it takes to bring a diamond to the market in the 21st century, and offers an insight into the day-to-day realities and costs of diamond mining at the extremes of the earth.

THE FUTURE AT A GLANCE

1. Diamond demand will continue to grow in real value terms, driven by the effect of the US economic recovery and the continued growth of emerging markets, especially China.

2. Positive demand growth for diamonds will almost certainly outstrip growth in production volume in the medium term. Across the value chain, organisations that are able to innovate and differentiate themselves will be best positioned to capture the opportunities created by this supply demand dynamic.

3. There will be strong competition from other luxury categories, and investment will be required to safeguard and nurture the diamond dream.

4. Brands will become increasingly important – consumers are seeking them out, and they give retailers an opportunity to differentiate themselves from generic propositions.

5. Online is rapidly increasing in importance as a channel for both research and sales of diamond jewellery to consumers, and will continue to do so – though the pattern differs by geographic market.

6. The midstream will continue to come under competitive pressure and, as a result, will professionalise and consolidate; businesses with scale and/or differentiated strategies will thrive.

7. Beneficiation will continue to be important for countries and regions where diamonds are mined.

8. Diamond production will decline slowly after 2020 with low likelihood of large, economically viable new finds.

9. As supply from existing mines decreases, mining will become increasingly complex and remote, and increasingly costly as a result. Investment in operational innovation will be required to drive productivity.

10. Technology will remain critically important to support the whole value chain, including in safeguarding the diamond dream from the risk of weakening consumer confidence as a result of undisclosed synthetics and treatments to natural diamonds.