01

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 the strength of consumer desire for diamonds.

Positive demand growth for diamonds will almost certainly outstrip growth in carat production in the next 10 years, given the lack of major new discoveries in the last decade and the projected production slowdown in several existing mines. Even under scenarios of volatile or weaker global economic growth, demand for diamonds is expected to show positive real growth in the next decade. 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.

A positive supply demand outlook is shared by a number of external experts. For example, in its recent publication on the global diamond industry, McKinsey & Company sets out four potential future scenarios for the diamond industry[2] (see Fig. 1). In every scenario, demand growth outstrips production growth. De Beers has undertaken some modelling of potential rough diamond supply and demand based on McKinsey's 'Diamonds are Forever' scenario, and the relative supply and demand curves are shown in Fig. 2. Other industry analysts have expressed similarly positive views (see Fig. 3).

FIG. 1: **FOUR FUTURE SCENARIOS FOR THE DIAMOND INDUSTRY**

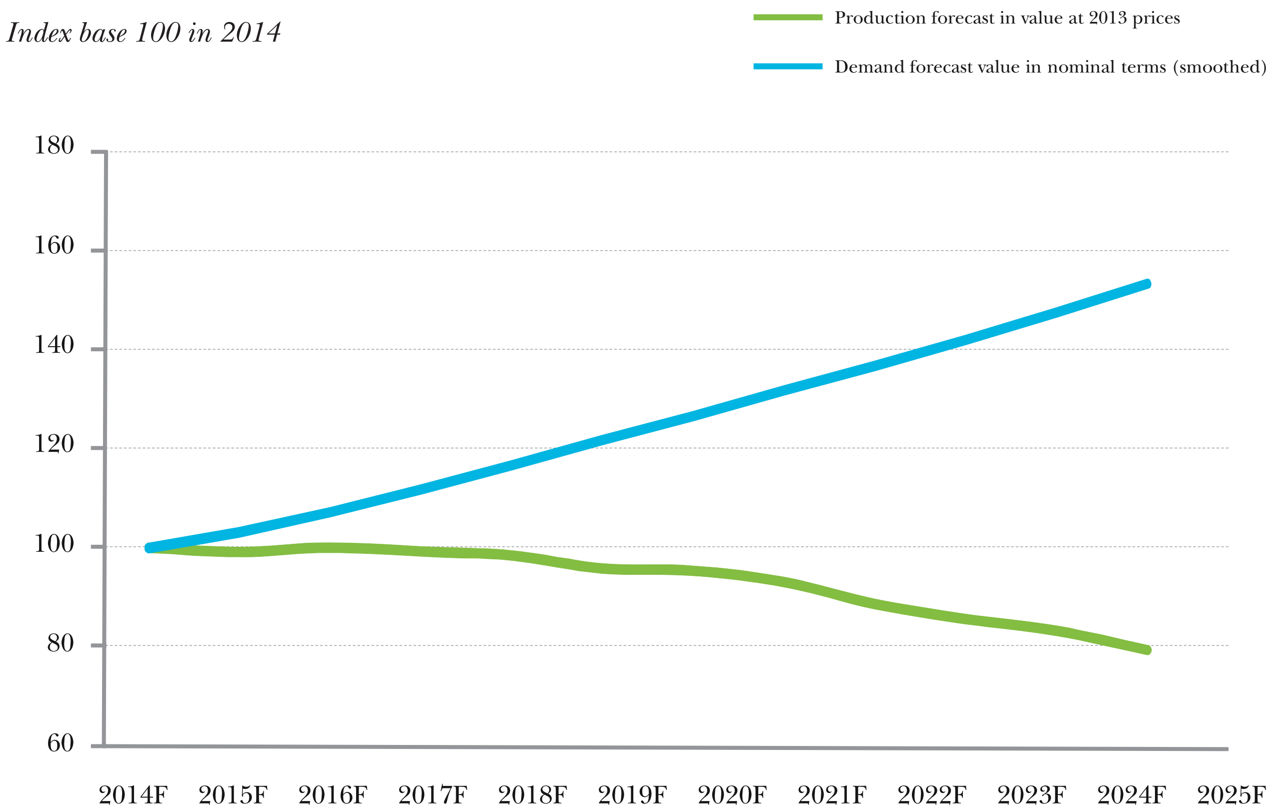
McKinsey recently published a report, *'Perspectives on the Diamond Industry'*. Building on four key uncertainties, the macro-economic outlook, future consolidation in the value chain, consumer attitudes to diamonds, and the supply of rough diamonds, the report identified four future scenarios for the global diamond industry.

1	**DIAMONDS ARE FOREVER**	Consumer demand grows strongly, fuelled by recovery in the US economy and continued above-average growth in emerging markets, especially China and India. Brands become more important and increasingly invest in promoting the allure of diamonds. Even with demand in Europe and Japan softening, the dynamics of supply and demand in this scenario mean that previously uneconomical mining projects become economically viable, so production is maximised.
2	**DEMAND SHOCK**	Diamond demand grows more slowly as key consumer markets such as the US, China and India experience weak growth. Companies lose the incentive to invest heavily in brands, and diamonds lose some appeal through a lack of investment in promoting the diamond category and consumers moving away from conspicuous consumption. Production remains stagnant but recycling of diamond jewellery increases as consumers encounter financial distress.
3	**FEAST AND FAMINE**	The diamond industry develops in a volatile manner, driven by high levels of global macro-economic uncertainty. Strong rises in demand are followed by sharp decreases, leading to scattered supply expansion. Lead-time between the demand and supply cycles implies a wide variation in prices. Mining companies strive to diversify their mining assets to manage volatility and adapt to the growing resource nationalism trend. Consumers increasingly move away from diamonds, and brands slow down their investments.
4	**EAST RENEWS GLOBAL GROWTH**	The industry enjoys strong growth driven by emerging markets, especially China and India. However, US growth is only moderate. The consumer base for diamonds widens as the emerging middle class grows and consumers show a distinct preference for brands. Diamond producers will continue to invest in developing new supply projects.

Source: McKinsey & Company, *'Perspectives on the Diamond Industry'*, September 2014

FIG. 2: **SUPPLY AND DEMAND CURVE BASED ON 'DIAMONDS ARE FOREVER' SCENARIO**

Index base 100 in 2014



Source: De Beers analysis, McKinsey & Company, *'Perspectives on the Diamond Industry'*, September 2014

FIG. 3: **DIAMOND SUPPLY AND DEMAND: PERSPECTIVES FROM TWO INDUSTRY ANALYSTS**

Goldman Sachs

DIAMOND DEMAND

Diamond demand is expected to expand at a Compound Annual Growth Rate (CAGR) of 11 per cent in nominal value between 2013 and 2017, driven by:

- Cyclical recovery in US consumer spend on luxury goods as economic growth recovers.
- Structural demand growth from emerging markets on the back of higher penetration of diamond jewellery among a growing middle class.

DIAMOND SUPPLY

Global natural supply is expected to increase at an average rate of 5.2 per cent between 2013 and 2017:

- Output in established mines falls as older mines come to the end of their life or move to underground mining. Going underground will make it difficult to maintain existing output levels due to additional haulage time and the technical challenges that come with underground mining.
- New mines coming online (including Grib, Gahcho Kué, Bunder, Karponskogo, Star-Orion South and Renard) represent only 17 million additional carats per year.

RBC

Demand is set to strengthen rapidly, determined by the recovery of consumer confidence in two key markets:

- The US, which represents the largest share of global jewellery sales. All indicators point to the fact that the US will remain strong going forward.
- China, which will underpin diamond growth in the medium term, as penetration of diamond jewellery pieces increases. Jewellery growth in China is expected to remain robust, with leading retailers such as Chow Tai Fook reporting 32 per cent higher retail revenue over the 2014 Chinese New Year.

Production will be increased by a set number of projects coming online including:

- Petra's proposed expansion of Finsch and Cullinan, which will lift production from ~3 million carats per year in 2014 to over 5 million carats per year in 2019.
- Grib: 4 million carats per year.
- Gahcho Kué: 4 million carats per year by the end of 2017.
- Renard: 1.5-2 million carats by the end of 2017.

Source: Goldman Sachs, *'Get engaged with Russian diamonds: Initiating as Buy'*, 9 December 2013
RBC, *'Diamond Digest'*, 4 March 2014

However, the positive supply demand outlook can be expected to be impacted by the cyclical nature of the industry. It is especially prone to the 'ripple effect' caused by de-stocking and re-stocking by midstream operators to fulfil lower or higher demand. Despite this, over the past 50 years rough diamond values have consistently recovered as economic growth rebounds (see Fig. 4).

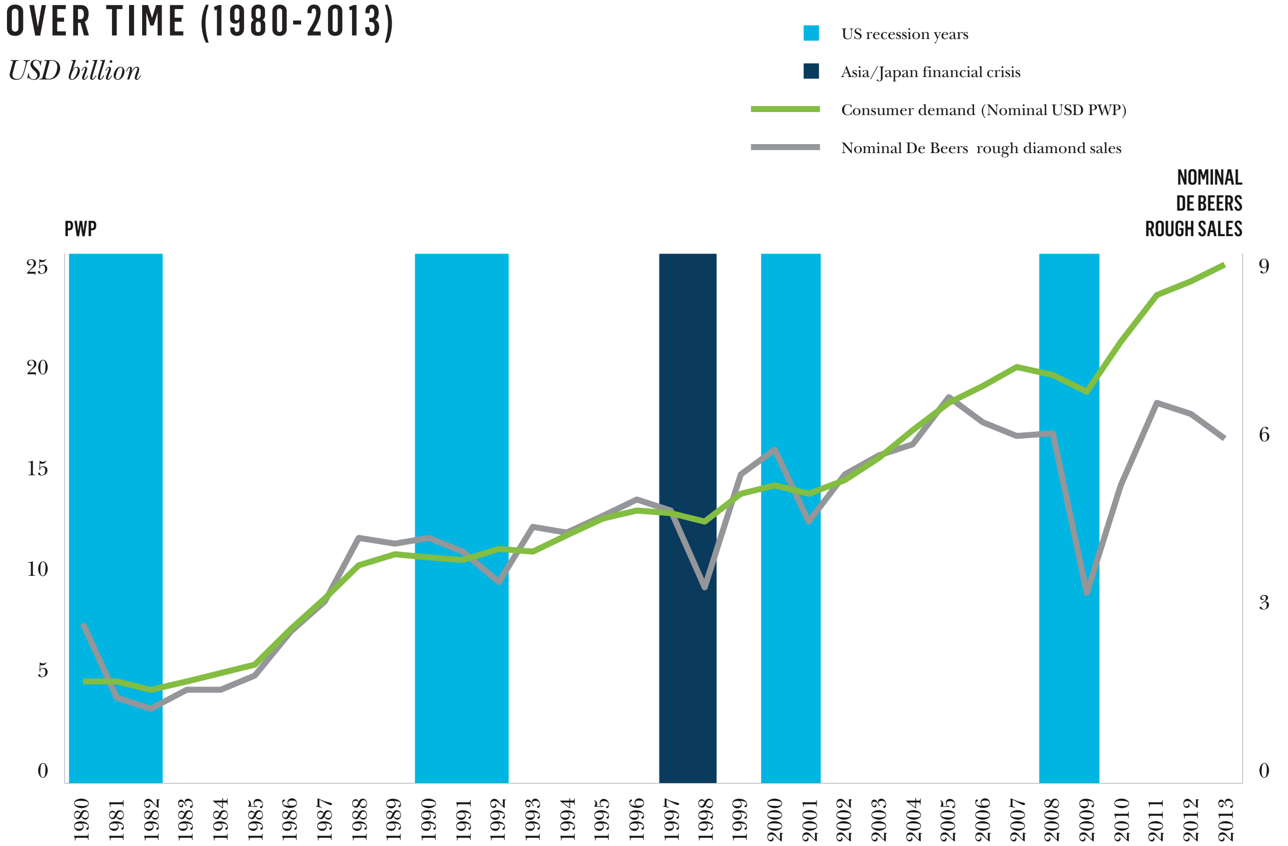
THERE ARE TWO KEY ASPECTS TO THE HEALTH OF THE DIAMOND INDUSTRY IN THE NEAR FUTURE

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 and treatments all pose challenges for the entire diamond industry.

The second is **innovation and differentiation** to take full advantage of opportunities created by the expected growth in diamond demand.

FIG. 4: **CONSUMER DEMAND AND DE BEERS ROUGH DIAMOND SALES OVER TIME (1980-2013)**

USD billion



Source: De Beers

With these aspects in mind, three areas of investment are likely to be particularly important for future growth:

1. Investment in **branding**, **marketing and raised retail standards** will help ensure that consumers, particularly among new generations and new geographic markets, do not drift away from the diamond jewellery category in favour of competing items, be they experience categories such as travel, 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, and will also safeguard consumers against the risk of undisclosed synthetics and treatments, which could undermine the long-term credibility of the industry.

Lack of investment in these areas will be value destructive for the industry as a whole.

Overall, supply and demand prospects 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 will continue to consolidate and integrate (including through vertical integration), and to professionalise, modernise and enhance its transparency. This will be critical if it is to stay relevant and profitable. Companies with scale will be better positioned to make such changes proactively and therefore to benefit from the continued growth of the sector. Niche companies will have to differentiate further their value propositions.

It is the responsibility of the entire industry, especially those organisations of scale, to continue to make these investments and secure the future of the industry in the face of changes and challenges to the sector. The ‘In Focus’ section of this Insight Report discusses these three investment areas: the changing consumer; the challenges in rough diamond production; and the imperative of using technology to safeguard the consumer and the industry overall.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