Love and Hate on the Rough Supply Side

“De Beers Does Not Feel the Love.” This is quite a puzzling subhead that appears on a note by RBC Capital Markets analyst Des Kilalea to Anglo American shareholders and other institutional investors. This sentiment might have been a typical British understatement reflecting the feelings of DTC clients towards their once “beloved” rough supplier.

Des Kilalea’s reference is to love that was lost not only because of the overly high rough prices but mostly because of the following: the perceived attitude and growing belief that mistaken strategies may have led to the increasingly miserable state of affairs in the midstream diamond sector. Anyone participating in some of the recent public meetings in India and Tel Aviv feels a sense of frustration bordering on hostility, primarily towards De Beers.

Objectively speaking, rough diamond prices from Alrosa closely follow – they may even mirror – the trends at De Beers. But De Beers is still seen as the price-setter of the industry, closely followed by Alrosa, Rio Tinto and others.

A New York DTC sightholder reminded me this week that during a visit to his office by De Beers CEO and President Philippe Mellier, the De Beers head bluntly said that if you can’t make money from our rough, then don’t buy it. What DTC sightholders are doing at the moment is precisely that – they have stopped (or reduced) buying rough. This sightholder didn’t mention Alrosa, though he should have.

This current situation reminds me of the James Bond film From Russia with Love, in which a British spy willingly falls into an assassination plot involving a naive Russian beauty in order to retrieve a Soviet encryption device that was
stolen by some hostile organization. James Bond showed us half a century ago in this film that, at the end of the day, different types of love can still lead to dangerous outcomes.

Des Kilalea’s remark about De Beers not feeling loved may also refer to Anglo American. In diamond mining, the profits are highest on the extra volume, as after a certain critical mass (when mining costs, overhead, etc. have been recovered) every additional stone sold adds directly to the bottom line. De Beers will announce its results tomorrow, but analysts now already expect that 2015 total DTC sales could be down more than 20%. (First half 2015 sales, to be announced tomorrow, are expected to come to $2.8 billion, compared to $3.45 billion last year.) Reduced volumes have a direct impact on the bottom line, something that is more difficult to swallow for a public company like Anglo American than for the basically state-owned Alrosa.

**Strategic Maneuverability in Adverse Times**

The weakness of the diamond market is evidenced by rejections and deferrals of purchases both at De Beers and at Alrosa. Both companies meet similar challenges in the market (soft Chinese demand, etc.), but the different structures of Alrosa and De Beers may lead to diverging crisis-time strategies. Moreover, De Beers is basically an African miner (with some Canadian exposure), while Alrosa is Russian (with some Angola presence). There are geopolitical issues that cannot be ignored. The James Bond movie played in the background of the Cold War. That’s behind us now. Or is it?

According to Des Kilalea, Alrosa also faces unique challenges which are beyond management’s control. These include threats of tighter sanctions on Russia (because of the Ukraine tensions) and the impact on the ruble exchange rate. [Though it is seldom publicly mentioned, at some point, Europe considered placing Russian rough diamonds on its sanction’s list. Belgium was able to avert that threat.] Moreover, Alrosa is controlled by the state and the local government (about 77%), with limited liquidity in the equity. While a weak rubble is a benefit to margins, these issues add to the risks of non-governmental shareholders in what is by any measure operationally a sound company.

In adverse times, Alrosa management can take stronger and more decisive actions to protect the diamond market than De Beers. We have seen that during the financial crisis in the 2009-2011 period, in which Alrosa’s mining production continued, with the government stocking the output. De Beers didn’t have that option and needed to cut down production. It is really fascinating that De Beers nowadays evokes such enormous emotions, so much anger, while Alrosa is perceived as a “friendlier” company.

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**The Forgotten Truth About Rough Prices**

The producers have forgotten something quite basic: polished ultimately drives rough, not the other way around. It is only when there are rough shortages (certainly not now) that producers will have super pricing power.

The producer belief is akin to iron ore miners believing that the price of ore drives the price of steel, rather than demand for steel driving iron ore!
idea whether this may happen, but it reflects a more positive attitude. It also reflects a policy choice – bound to be welcomed by De Beers. The bottom line is that Alrosa has more strategic latitude, and a greater scope of maneuverability, than De Beers.

Pure Upstream versus Vertical Integration Models

The midstream (diamond manufacturers and traders) section of the value chain finds more comfort in dealing with Alrosa – or maybe one should say feels “less threatened.” Alrosa is basically a mining company – expanding outside Russia (in Angola) as well. In terms of carats, it is the largest diamond miner in the world. Last year, out of a global diamond production of some 131 million carats, 28% came from Alrosa, 25% from De Beers, 11% from Rio Tinto with the remaining 36% divided among the smaller players.

Alrosa has no downstream ambitions. It doesn’t operate a grading lab; it doesn’t invest and promote its own Forevermark kind of diamond brand; it doesn’t have recycling operations purchasing polished diamonds from retailers; nor does it operate the equivalent of a De Beers Jewellery retail operation, just to mention but a few of the De Beers “new” core businesses. Maybe the time has arrived for Anglo American to review these downstream activities that were developed over a period of well over a decade and that represent a drain on its cash and profits. None of these activities, as far as is known, have yet to deliver a profit to the company – while the costs (and investments) are huge.

On the core rough mining and marketing activities, the business models of De Beers and Alrosa are quite similar. Both use auctions (spot sales) and long-term contracts. For the 2015-2017 contract period, Alrosa has 62 agreements with sightholders. It has a minor exposure to polished sales – a historical leftover – and has done some test sales (up to $2.6 million – near to nothing) through Sotheby’s auctions. To shorten the pipeline, it encourages long-term supply relations with jewelers, such as Tiffany’s, Chow Tai Fook and others. And, of course, Alrosa has its own variations of Best Practice Principles, called Alrosa Alliance Responsible Principles Program. The conditions of the long term contracts of De Beers and Alrosa are not identical. Our understanding is that the Alrosa contracts are tighter than De Beers. A refusal basically means that you are out of the contract. Hence
it’s becomes a question of who will become the sacrificial lamb and be the first one to reject the Alrosa sight and lose their sight. But that point may still be far away, as Alrosa may simply not offer the goods.

**Oligopolistic Producer Structure with One Price-Setter**

The erstwhile cartel structure was replaced around the turn of the century by a more oligopolistic structure, but there is no doubt that many – if not all – of the current industry woes can be attributed to a rough supply mechanism with one price-setter and others that follow. In one sense, some producers publicly express “disdain” (for lack of better word) with sightholders that continue to purchase rough diamonds that they know are unprofitable.

The tragedy is that whenever the market allows De Beers to increase prices, it is very quick to do so, but when the market warrants a reduction, it is slow or hesitant to do so – if at all.

If there was a competitive market in which the market price of polished played a role in the raw material market, rough prices may well have been some 20-30% lower today. The midstream might have been much healthier than it is today. For instance, the balance sheets would show profits, bankers would embrace the industry with greater enthusiasm, and the midstream could have invested more in marketing and promotion. It would not be a utopia, but it would certainly not be anything like the current near-disaster area. The tragedy is that whenever the market allows De Beers to increase prices, it is very quick to do so, but when the market warrants a reduction, it is slow or hesitant to do so – if at all.

**Alrosa 2014 Rough Diamond Sales Structure**

<table>
<thead>
<tr>
<th>Weight</th>
<th>0.3-0.9 ct</th>
<th>0.9-1.8 ct</th>
<th>1.8-10.8 ct</th>
<th>&gt;10.8 ct</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
<td>45%</td>
<td>15%</td>
<td>9%</td>
<td>5%</td>
</tr>
</tbody>
</table>

39.6 min cts <1%

<table>
<thead>
<tr>
<th>Weight</th>
<th>0.03-0.3 ct</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage</td>
<td>30%</td>
</tr>
</tbody>
</table>

Industrial (less than 0.03 ct or less than 1.5 mm)

$ 4,901 min

11%

34%

14%

16%

22%

3%

by sales value
Conventional wisdom has it that shareholders should applaud every extra dollar De Beers can squeeze out of its clients. But that’s purely a short-term and short-sighted attitude that is helpful to bonus-based management performance. It is not conducive to the long-term development of the diamond market and to De Beers itself.

De Beers talks about branding, about consumer confidence, about loyalties to its De Beers Jewellery and Forevermark brand. At the same time, it has been successful – yes, it has finally succeeded – in virtually destroying the clients’ loyalty to the De Beers brand as a rough supplier. We’re talking about a loyalty that has been nurtured for well over a hundred years. To quote a New York sightholder: “Doesn’t Cutifani understand that De Beers is destroying the market?”

Let’s look at figures. This month’s DTC sight “could have been well below $200 million,” estimates Kilalea. [Adding De Beers auction sales, it may have been slightly above $200 million.] This compares with an average for the previous 10 years of sights in July of approximately $625 million! Any way one looks at the rough – it is simply too expensive to process profitably in an already well over-supplied polished market.

For the diamond market, many diamond players see a worse second half in 2015, but, and this is quite worrisome, too many believe that 2016 is also already “written off.”

Perceptions have the inherent danger of becoming self-fulfilling prophesies. They certainly influence buying behavior. Serious rough replenishment will only commence when rough prices are viewed as having reached their bottom. As of now, only the sightholders have acted and refused to buy. If this continues it will be the banks who will refuse to finance sights. That will be the real tragedy for the producers.

Impact on Anglo-American Earnings

Last year the contribution of De Beers’ earnings to Anglo American was $923 million. This year, it may plunge by a hefty 50% down to $465 million. The final figure will depend also on the midstream’s accessibility to finance, something it won’t be able to get without producing margins. It is a vicious circle: Producers deny profitability to the midstream, and consequently the banks deny financing to the midstream.

De Beers will deliver a severe cash hit to Anglo American – and its CEO, Mark Cutifani, ought to consider whether a different management approach could have led to better results. In the past, client loyalties were always the company’s “saving grace” during adverse economic times, having clients quite willingly moving stocks from De Beers into their own inventories. They were also convinced that the De Beers marketing strategies would almost...
guarantee that they wouldn’t lose money on this “sharing of the stock” burden. Back then, clients didn’t mind overpaying either as they were confident that, in the long run, their coveted sightholder status would pay off and De Beers would allow them to make money. This is no longer the case.

**A Slight Recovery is Predicted Only By 2017**

RBC’s predictions are quite unequivocal: “Our view is that a price strengthening in the second half of 2015 is unlikely in the rough market, on average. The trend in the USD [exchange rate] is another important element in the price trend given that rough and polished tends to be priced in dollars. The strength of the USD is not helpful. A great deal depends, though, on how De Beers and Alrosa act; if they chase volume then prices will weaken, we think, and the independents will see more erosion in margins. For De Beers, the near-term sales strategy decided will, in part, be determined by Anglo which faces tight cash inflows across the group. We believe that De Beers will need to adjust prices downwards, though big reductions are unlikely, we believe, so volumes will probably suffer.”

There are, indeed, many indications that De Beers will prefer selling fewer diamonds than reducing prices – unless a downward price spiral hits it. The Russian strategies seem supportive of such policy. It must be kept in mind that the diamond pipeline functions as one supply chain. Hence a weak mid-stream will only lead to a long term drop in sales.

**Matter of Sentiment**

In this article, we are extensively relying on analysts’ views, especially those of Des Kilalea. This is for two reasons: Sometimes, for the diamond trading community, it is quite important to know how “outsiders” view our business. The other reason is to understand what the shareholders and executives of the mining companies read, see and hear. They are the ultimate decision makers – to these corporations, the views of the industry are not really of any interest to them – nor does the industry have a platform to communicate. With maybe one or two exceptions, I am not aware that Anglo American’s Mark Cutifani has devoted time to understand or listen to the concerns of De Beers clients. Cutifani is a hierarchical leader – he operates through, and relies on, a dozen or so top executives who report to him. Mellier and some other De Beers (financial) officials have access to him. Cutifani listens to them.

How do analysts see the near future? “The next DTC Sight starts on 21 August and this will be the last opportunity for goods to be sold and processed for the busier year-end retail sales season,” says Kilalea. “It is our view that another small sight is likely given excess polished inventory and falling prices and softer growth in China. While the US market (about 40% of global diamond jewelry sales) remains robust, the diamond sector needs China to produce greater sales growth to absorb excess pipeline inventory. Besides, the leading diamond banks are becoming ever stricter not only on how much rough they finance, but also the extension of long credit lines to the retail sector by diamond cutters and polishers.”
Continues Kilalea: “Forecasting the next Sight is not easy, but our view is that anything over $300m probably looks unlikely at this stage. If this trend continues, De Beers’ natural diamond sales could be significantly lower than the $5.8bn ($6.5bn in FY14) we expected earlier this year.”

Small independent producers are also feeling the chill: While independent diamond producers have been able to sell their production, this has largely been because their prices have been lower than those of De Beers and Alrosa. Diamantaires suggest that they will continue to source goods where they are cheapest. However, acknowledging the very quiet demand conditions in the market, some miners are pushing August sales out a bit later to capture more attendance at tenders when the summer ends.

The View from an Anglo Perspective
Anglo American is a mining conglomerate in trouble. This isn’t caused by De Beers – to the contrary, De Beers was a major (sometimes “the” major) contributor to its profits. That will change now. De Beers is weighing on the share price. Analysts are now calling on Anglo American to cut its dividends! Some of Anglo American’s subsidiaries (such as Kumba ore) are not paying a dividend to the parent company.

Des Kilalea and some of his colleagues believe that “Anglo should either cut the interim dividend or warn that the final dividend will be reviewed.” What does this mean to ordinary shareholders? The annual $0.85 per share dividend absorbs $1.1 billion of cash. How can a payment like that be justified when the company sees its net debt growing from last year’s $12.8 billion to an estimated $13.8 billion in 2015?

What shareholders are being told is that for De Beers to flourish, “it will need to adjust prices downwards.” As realistically speaking – and knowing the De Beers management – big reductions are unlikely, the volumes sold to the market will probably suffer. On the eve of the De Beers results announcements, it is important to monitor Anglo American shareholder and company reactions.

To conclude with the words of an Indian analyst: “In short, the producers have killed the “Goose who laid the Diamond Eggs” and the entire industry will suffer for it.”

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1 year subscription - US$590 * Individual issues of DIB are available for purchase online at: www.diamondintelligence.com

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