2016 DIAMOND INDUSTRY OUTLOOK

The fundamental supply and demand trends of the diamond industry continue to be positive and, by acting to strengthen its competitive position, the diamond industry can anticipate a positive future.

In the two years that have passed since the publication of De Beers' 2014 *Diamond Insight Report*, new global and regional trends have been identified. The main changes relate to macro-economic trends in emerging economies, especially in China and India, as well as volatility in world economic growth forecasts.

These developments will demand that diamond industry participants strengthen their competitive capabilities even more through better planning and more investment in innovation and marketing.

A MORE VOLATILE FUTURE

Since 2014, the world has experienced moderate annual global growth at 2.5 per cent,[1] although this has been uneven across markets and is, in some regions, characterised by political uncertainty. Ultimately, consumer demand for diamond jewellery has remained strong; indeed, it has been higher over the past three years than in any other three-year period.

But there have also been industry challenges. While consumer demand for diamonds is still growing in the US, growth has slowed in China and declined in India. Midstream players faced fresh pressure in 2015, when inventory indigestion led diamantaires to destock, impacting rough diamond sales. Furthermore, diamond producers face increasing cost pressures as production comes from ever deeper mines.

Volatility is here to stay as global markets are likely to continue to fluctuate, potentially increasing the diamond industry's inherent volatility. Consumer preferences will continue to evolve, and innovation by global luxury brands and new online propositions will generate strong competition for the industry. The midstream will be required to continue its process of professionalisation, and the upstream will continue to face cost challenges. Fig. 1 sets out nine of the fundamental trends De Beers believes will shape the industry in the next 10 years.

FIG. 1: **NINE FUNDAMENTAL INDUSTRY TRENDS**

	1	2	3	4
TREND	ECONOMIC VOLATILITY	CONTINUED GROWTH IN DEMAND FROM EMERGING MARKETS	NEW CONSUMER PREFERENCES	RETAIL INNOVATION
DESCRIPTION	Global economic growth will continue to be volatile, as businesses become more highly leveraged, markets become more interconnected, current account imbalances widen, foreign exchange fluctuates and geopolitical instability increases. The diamond industry is likely to experience increased volatility under any macro-economic scenario, relative to recent years.	Positive consumer demand growth is likely to continue to come from Asian consumers, particularly Chinese and Indian, driven by increasing household wealth over the next 10 years but at lower levels than previously assumed. Due to increasing international travel, national demand may not necessarily be domestic.	Consumer demographics will evolve, with retiring and elderly consumers expected to generate the majority of global urban consumption growth by 2030, and with Millennials becoming the largest age cohort in the US. Consumer preferences can be expected to change, with an increased focus on self-expression; as a result, design and branded jewellery will continue to increase in relevance. Economic empowerment will drive self-purchases especially among women, and demand for lower entry-point diamonds will rise. Consumers will continue to become more knowledgeable and push for ethical products with known provenance.	Continued innovation by global luxury players – especially in retail, omnichannel, attraction of international travellers, increased product offering (eg customisation) and more sophisticated consumer segmentation – will generate strong competition from other luxury categories. Retailers focused on branded diamond jewellery will be able to differentiate themselves from generic propositions.

5

INCREASING PRESSURE ON THE MIDSTREAM

Financing challenges are expected to persist, driven by tighter lending standards and less availability, placing additional pressures particularly on midstream players with outdated and unprofitable business models.

Diamantaires will need to operate under increasingly rigorous professional standards, such as compliance with IFRS.

There is expected to be increasing transparency of the supply chain through digitalisation, leading to potential disintermediation of players without value-added services.

Retailers/jewellers are likely to demand more value added from their midstream suppliers.

6

HIGHER MINING COSTS

A larger share of production is expected to come from ever deeper mines, which are complex and costly to operate; additional investment is required by producers to drive productivity.

Unit capital cost is expected to continue to rise.

In addition, unit costs of energy, labour and consumables are expected to increase.

Fluctuations in foreign exchange and energy prices will cause higher cost volatility.

7

PREDICTABILITY OF ROUGH DIAMOND PRODUCTION FOR THE NEXT 10 YEARS

Rough diamond production is expected to remain predictable and relatively stable over the next 10 years with a relatively sparse new project pipeline.

It is expected there will be increases in the short term, given investments in the last 10 years.

Large economically viable finds will remain unlikely.

8

PRESSURE FROM PRODUCING COUNTRIES TO MAXIMISE VALUE

Diamond producing countries, in particular in southern Africa, will continue to look to maximise the value of the diamond assets.

An expected rise in local beneficiation will likely put increasing pressure on midstream margins.

9

INCREASING CAPACITY TO PRODUCE SYNTHETIC DIAMONDS AT A LOWER COST

While consumer demand is currently negligible, the capacity to produce synthetics for gem applications is likely to continue to expand.

Over time, the production cost and value of synthetics are expected to reduce.

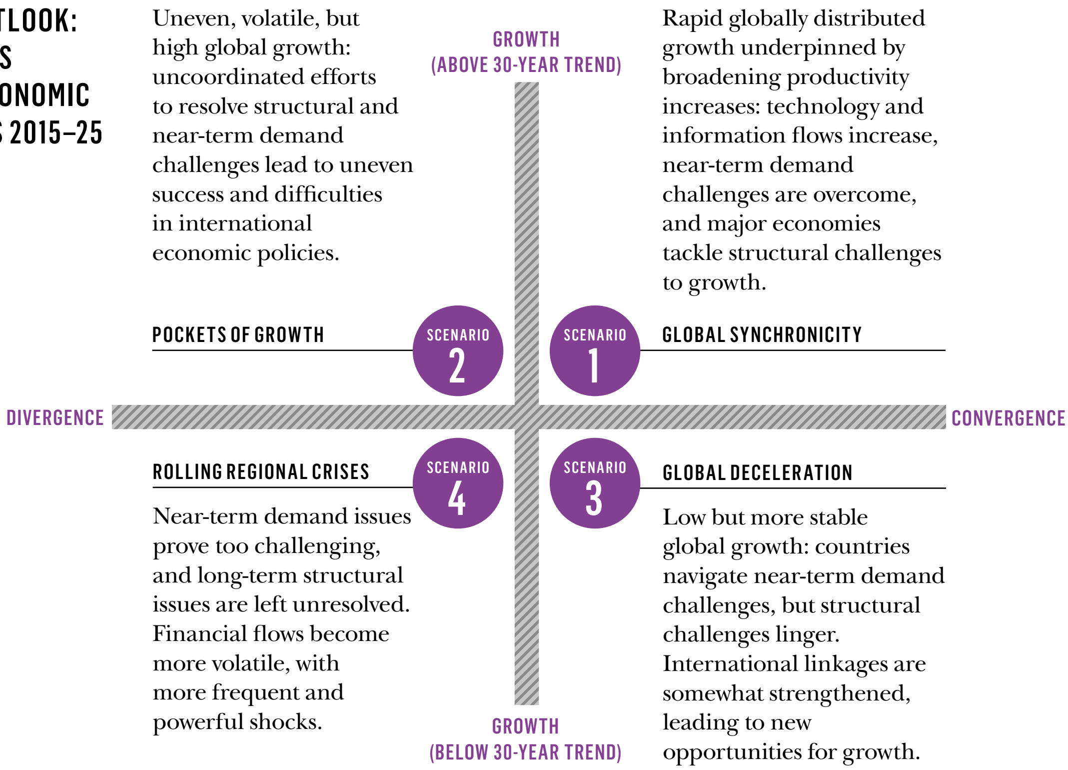
Source: De Beers

The diamond industry also faces a number of uncertainties. First among them is the overall macro-economic environment. The outlook for the industry and consumer demand is intrinsically linked to the strength of the global economy. Fig. 2 refers to the macro-economic scenarios published by McKinsey Global Institute[2] in 2015.

There are three additional uncertainties across the value chain that are likely to have significant implications for the industry:

- **Consumer attitudes to diamonds:** Over the next decade, consumer demand could continue to broaden as diamond jewellery retailers innovate and invest to keep diamond jewellery relevant for new consumer demographics; alternatively, new consumers could move away from diamonds if the industry fails to invest and innovate to keep diamonds relevant to them, and other experiential or luxury categories therefore become more relevant.
- **Evolution of the distribution channel:** The next decade could bring increased corporatisation and consolidation to the midstream; alternatively, continued fragmentation and relative opacity could characterise the midstream.
- **Supply of diamonds**: Though rough diamond production levels are likely to vary marginally around a known trend in the next decade, overall diamond supply may continue to expand slightly due to technological breakthroughs in diamond mining and in cutting and polishing as well as a greater supply of recycled diamonds.

FIG. 2: **MACRO OUTLOOK: MCKINSEY'S GLOBAL ECONOMIC SCENARIOS 2015–25**



Source: "Shifting tides: Global economic scenarios for 2015–25." McKinsey Global Institute. January 2016 update.

Overall, most sector observers remain positive on the fundamentals of the industry – recent analyst reports state that demand growth for diamonds will continue to outstrip growth in carat production, predicting low single-digit nominal demand growth in the medium term (Fig. 3).[3] At the same time, it is clear that the macro and competitive environment will continue to be challenging and volatile.

THE IMPERATIVE OF PARTNERSHIPS

The diamond sector is used to tackling challenges. In the past, the industry has thrived due to its ability to create strong partnerships – today this characteristic remains more important than ever.

De Beers believes that consumer demand will continue to be the key source of value – and retailers, manufacturers and producers must work together to preserve and enhance the diamond dream in established, developing and emerging markets and across all consumer segments.

This will require investment and innovation across the value chain – in new retail formats, value-adding strategies in the midstream, technological innovation to ensure continuous supply and creative partnership with producing countries and communities to ensure the benefits of diamonds reach everyone.

FIG. 3: PERSPECTIVES FROM TWO INDUSTRY ANALYSTS ON THE VALUE CHAIN

BANK OF AMERICA MERRILL LYNCH AND MORGAN STANLEY COMMENT ON VARIOUS ISSUES ACROSS THE DIAMOND INDUSTRY VALUE CHAIN

BANK OF AMERICA MERRILL LYNCH

DEMAND

Polished diamond value (in nominal US dollars) is expected to expand at a Compound Annual Growth Rate (CAGR) of four per cent between 2016 and 2022, driven by:

- Positive US consumer confidence indicators; however, high end retail under pressure.
- Five per cent per annum growth in China due to campaign against corruption and conspicuous consumption.
- Slow European recovery.

MIDSTREAM

Small margins, liquidity, and fragmented structure have put huge pressure on the industry:

- Credit will be increasingly constrained in the industry, leading to liquidity issues.
- Liquidity hole will remain, but will lead to bankruptcies and consolidation, benefiting the industry long term.

SUPPLY

Global supply of rough diamonds (in carats) is expected to expand at a CAGR of three per cent between 2016 and 2022, peaking in 2021:

- New exploration and finds can be expected to take place in ‘tougher’ postcodes, which involve political and physical difficulties.
- Improving technology however is optimising cutting and polishing so that greater yields are being realised year on year.

MORGAN STANLEY

DEMAND

Diamond jewellery sales are expected to grow at a four per cent CAGR (in nominal US dollars) between 2016 and 2021, driven by:

- US providing a solid core, contributing 42 per cent of polished demand.
- Weakening Chinese consumer sentiment on luxury goods due to the economic slowdown and recent volatility in the stock market.

MIDSTREAM

Pressure on midstream margins will be exacerbated by tightening financing and liquidation of polished diamonds, as cutters and polishers try to obtain any possible cash flow:

- Recognition (of corporate loan defaults by jewellers) may further curtail liquidity available to the midstream and reduce appetite for rough diamonds.

SUPPLY

Global supply of rough diamonds (in carats) is expected to expand at a CAGR of one per cent between 2016 and 2021:

- Diamond supply growth will reach a post-financial crisis high of 143 million carats, or only 13 per cent below the pre 2009 crisis peak of 168 million carats.
- This is driven by growth mainly in Canada (Gahcho Kué, Stornoway) and Russia (ALROSA and Grib reaching full capacity).

Source: “Global Diamonds Metals & Mining,” Bank of America Merrill Lynch, June 2016; “The PIPE – diamond intel,” Morgan Stanley, March 2016; “Why we’re less bullish than the street,” Morgan Stanley, April 2016.