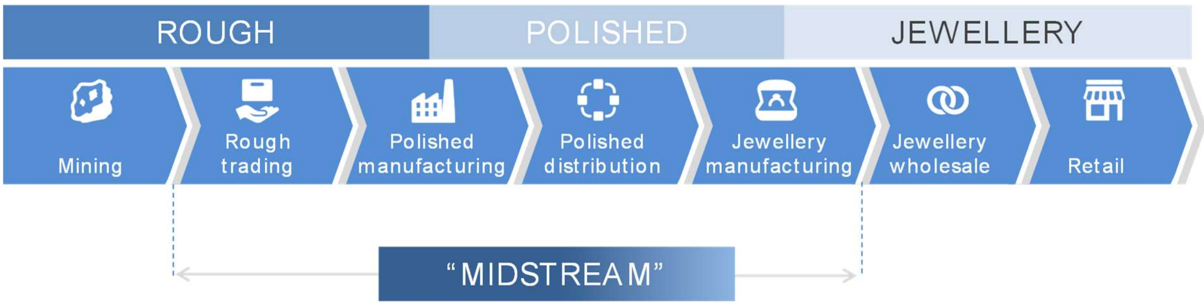
DIAMOND INDUSTRY IN DEPTH
CURRENT THEMES:
THE MIDSTREAM PROBLEM

About the current themes series
The diamond industry is closed and opaque. This series of papers will touch on a number of the key themes impacting the diamond industry and provide insights on what this might mean for rough diamond mining companies.

Defining the midstream

The midstream of the diamond pipeline are the participants who occupy the space below the diamond mining companies and above the jewellery wholesalers. These companies are key to the industry. They form the customer base for diamond mining companies, and convert rough diamonds into the final jewellery pieces. The health of the midstream is critical to the stability of the diamond pipeline.



The midstream is fragmented and predominantly comprised of family-run companies. Although the industry is relatively closed, the initial capital investment required to establish manufacturing operations is low. As a result, the barriers to entry are low. In general, midstream players rely on debt financing to fund working capital needs. They are leveraged plays, borrowing from specialist banks and banking syndicates. Among themselves, midstream players extend credit to eachother, creating webs of interdependency.

The emerging midstream challenge

The current problem in the midstream is often coined as the "midstream profit squeeze". The issue has emerged as a result the accumulation of a number of factors over the last few years. The outcome has been an erosion of margins in the midstream leading to a deterioration of midstream balance sheets. The main contributors to this have been:

Producer policy of 'fully priced' rough diamonds. Over the past few years, producers sell diamonds at the secondary market price, and/or the highest possible price at which a customer will make a rough purchase. This has happened to such an extent that secondary market prices have often been lower than producer prices.

Primary rough purchasers (such as De Beers' customers) have had a role to play in creating this situation. They willingly purchased unprofitable rough while not (perhaps) accepting the producers' long term pricing intentions. While some of the reasons for doing this are understandable, this behaviour is nonetheless an important factor in the current scenario.

Price prisoners at both ends. Midstream companies have a challenge because they are, in effect, 'price takers' for both rough and polished. They do not exert much control over rough prices. Rough prices are more or less the same wherever you buy from. On the other side, diamond manufacturers often don't have much control over polished diamond prices. There is a market clearing price for polished. There are exceptions to this, but this seems to be the prevailing situation for many manufacturers.

Midstream debt financing has the potential to become more scarce. Added to margin pressures from high raw material costs and almost perfectly contestable downstream markets, the midstream is suffering from increasing scarcity of finance with one major bank (Antwerp Diamond Bank) exiting the industry and other banks freezing or limiting their positions given the impairment risks. The deleveraging in the midstream increases the cost of capital. In addition, when markets are weak, cash flow management becomes is more challenging.

Part of the problem is cyclical and down to market conditions. The global economy has faced considerable uncertainty over the last few years. There is a greater austerity for businesses and consumers. This has gone on for some time, but it's still part of a cycle.

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How will diamond miners react

Looking for structural price growth. Rough diamond prices fell 15% during 2015. Although we saw some price falls in January 2016, in general prices are firmer with an expectation that Q2 2016 will be weaker with the seasonal cycle. Putting aside short-term price movements, rough diamond miners will need to look for structural price growth. The thin margins in the midstream will mean that it is difficult to secure price growth by taking economic rent from the midstream.

Examining their distribution mechanisms. In the current environment, there is more even bargain between rough producers and their customers. Producers are finding it difficult to price above the prevailing market. At the simplest level, mining companies face a trade-off between price and more flexible contracts for customers (and therefore more volume volatility). Longer-term, producers may revisit their distribution models. They may change the services they offer rough diamond customers. They could even contract manufacture rough and distribute polished. One thing's for sure: it's no longer as simple as choosing whether to auction or sell to regular clients. There will be scope for more innovation, and potential value add through sales excellence.

Diamond industry changes

Gemdax believes that the evolution of the midstream is one of the handful of 'fundamental issues' that the sector faces. Along with the emergence of man-made diamonds, issues include the evolution of industry financing, the possible advent of diamonds as an investment vehicle, and how the sector will effectively generate consumer demand. All these factors are interdependent. Taken together there is a challenging time in store for all players. But also unprecedented opportunity.

About Gemdax

We are a diamond industry specialist consulting company. We primarily undertake strategy and analytics work across the supply chain.

We have worked across all the diamond centres. Clients have included government organisations and enterprises, public private partnerships, investors, diamond mining companies, trade/pan-industry organisation and service providers. Our clients are based in a range of geographies including Australia, Belgium, Botswana, Canada, Israel, India, UAE, and UK.

The firm has operated in the industry for over 15 years giving it deep knowledge, data and market intelligence. This specialisation enables us to deliver in-depth, accurate insights into the industry in short timeframes.

Gemdax is an independent firm with no investors from the diamond industry. It also does not hold interests in the diamond sector.