

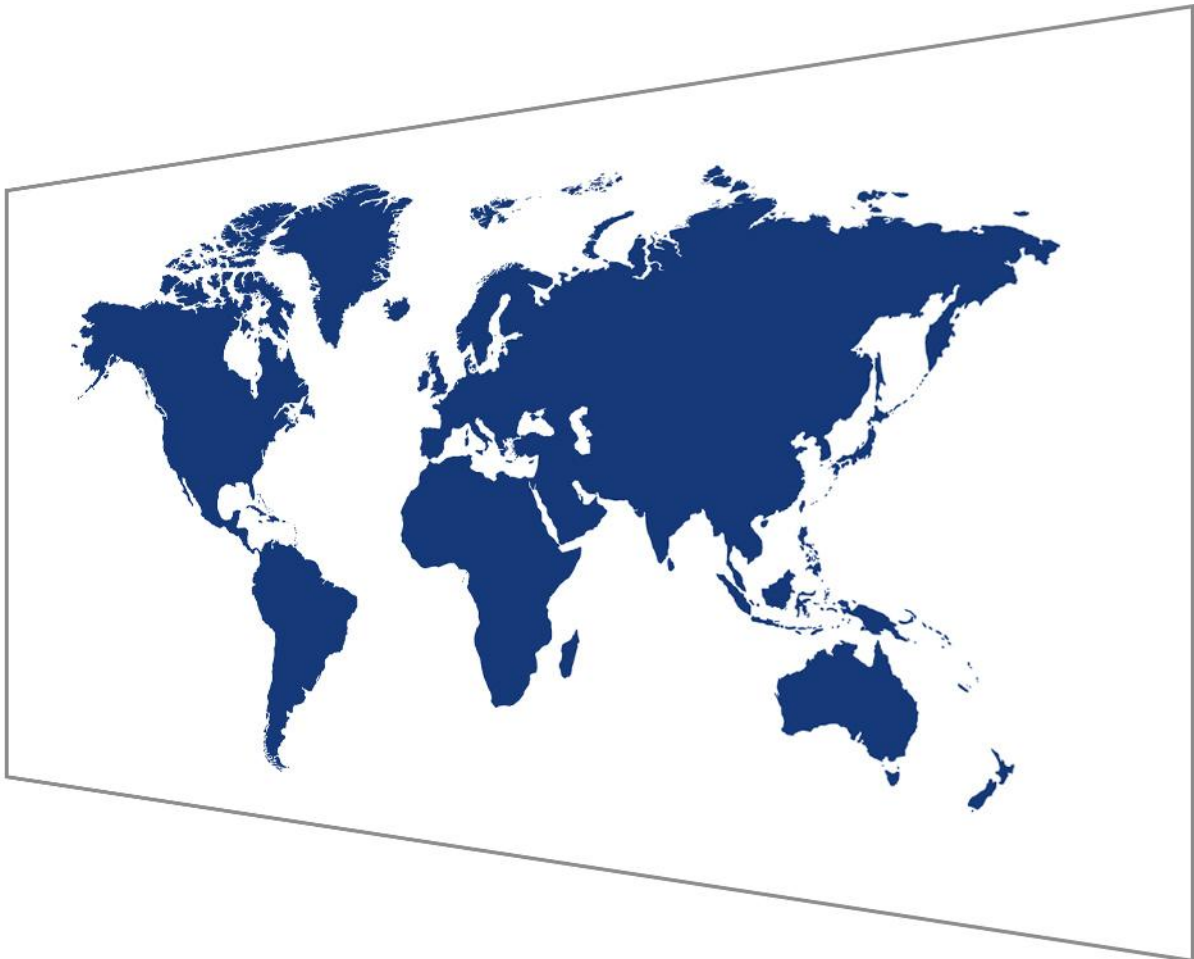


Bonas

Diamond Brokers & Consultants

Market Report

October 2010





Rough

The rough/polished contrast has been puzzling for so long that we'll just have to accept it as the norm for now. The rough situation seems to be based simply on too many people and too much money chasing limited supplies of (reasonably priced) rough. Apart from a few niche area (geographical or goods-wise), polished markets are currently uninspiring at retail level. People do hope to see some reasonable growth during the U.S. Christmas season.

Many sightholders feel concern at a situation where manufacturing margins have been eroded on DTC goods and are simply not there in goods from most other productions. The continuing march towards tenders is particularly worrying for those with large investments in infrastructure, well organised supply lines and branded and corporate outlets.

ANTWERP

We've seen the same scenario this month as in several previous ones: excitement in the first days of the sight, accompanied by strong premiums (double digit this month on quite a large number of boxes) then calm again in the days after that. Now, one week after the sight, a lot of the premiums have come down to around 5%, with large goods losing the most ground.

For a sightholder there are two ways to look at the goods: a) compare to other rough and be happy, b) compare to polished and be less happy. In fact, for any manufacturer, whatever his source, margins have become tight. As reported before, the bigger the size, the thinner the margin has become.

In the first week of October BHP auctioned its term contracts that represent 60% of total sales. On average these contracts were sold at a 3-4% premium, which is slightly higher than last time.

Rough in general remains expensive and we believe this is likely to continue for another few months. It is difficult to estimate exactly when polished reality will finally hit home, but we believe the pipeline is once more pretty full, global production capacity is probably too big and margins are tight.

We are now heading towards the most important sales period of the year, the result of which will be an indicator as to whether this rough price level is sustainable or not.


Mumbai

The dip and the resistance we felt coming in the rough market last month hasn't come through. Prices of rough, first hand and second hand remain high. At BHP, prices of + 2cts were up approximately 2%, medium sizes 2.5%, and smalls 3%. The main thing to note is that they haven't come down. The reason for this is the relative scarcity of goods. Alrosa has also increased by 2-3% but assortments are reported to be consistent.

What hasn't changed compared to last month is that manufacturers of medium and large goods are still quite picky about what they need. They are prepared to pay 1-3% more for those articles but nothing like we see in some 'Indian goods' where premiums have been robust.

For the moment it looks as if all producers are holding prices firm and that any increase in margin for the manufacturer will have to come from higher polished prices. A lot will depend on polished sales in this last quarter, because one can feel the tension in the market.

DTC assortments were well received. The Indian boxes assortments appeared to be the same as last month but better in value due to changes in proportions. Indian Flats was the one area where most felt that the assortment was weaker despite a high price on paper. MB/Clivage



3grs+7 has deteriorated in the last three months and is difficult to make money on after premiums.

Manufacturing is at full pace with only a few days left before closure for Diwali. Most companies are busy settling their financial accounts as Diwali is the time for sharing the profit/loss. It is surprising to see no new bankruptcies which are common at this time of the year.

Surat

It is very unusual to see demand for rough at this time of the year, when all the factories will be closing in three weeks' time. This can be attributed to (i) retention of workers who are not so easily available (ii) market conditions are favourable, with not enough manufacturing stock in the pipeline (iii) speculation that people will need rough after Diwali to run their factories and (iv) that DTC will hike rough prices in the near future.

The scene in Ahmedabad and Bhavnagar is more or less the same as in Surat. Though there is a labour shortage there is no switching of jobs which is usual at this time of the year as nobody wants to miss their bonus. They have started paying more attention to make and a lot of repair work is done to kill time. This is because most of the small manufacturers usually avoid buying more rough and stocking during this period.

Tel-Aviv

Sight goods are expensive but most other rough is even more so. The profitability on DTC goods is very tight and if one adds a premium the profit evaporates completely. Manufacturers find buying polished to be cheaper than buying rough and manufacturing in India or China. The high rough prices, stagnant polished prices, and imminent end to the season has increased the quantity of rough available on the market.

The reasons for second hand DTC boxes fetching low double-digit premiums in India seem to be as follows:

After struggling to find workers for the factories in India and paying higher salaries, the factories must be fed continuously; DTC's consistent assortments are a necessity for some manufacturers who have difficulty buying other rough. Non-DTC goods are often more expensive than boxes with the premiums.

Unfortunately a 'magic bullet' solution for resolving this continuing non sequitur does not appear to exist.

Premiums for DTC boxes have fluctuated more this sight than last with the upcoming Diwali a factor. Demand from Israeli non-sightholders is mainly for 8grs and down for manufacturing in the East.


New York

There is nothing new on the manufacturing front in New York. As with other centres rough from any source, particularly in the larger goods, is considered too expensive to manufacture.

A small amount of Canadian rough has been traded on the market but the vast majority of this is shipped straight out of the US for manufacturing or re-selling.

Southern Africa

Overall the mood has improved. *Ex-plan* is always welcome as the appetite for rough continues to grow.



In Botswana employment has climbed back in most cases to mid – 2008 levels, enabling people to process the increased rough intake. Clients are generally satisfied with the overall situation in Botswana. That said, there is potentially increasing labour unrest with DTC Botswana workers recently going on strike.

South Africans and Namibians who are non-sightholders still complain about availability of rough to feed their businesses. South African companies are even more sore as the issue is not lack of rough as such, but that rough from SA miners is priced much higher than they can afford at various tender houses. Sourcing rough from the SDT is no longer an option for many, and many will say that when legislation is changed it should stipulate that all diamonds mined in South Africa should be for local processing only.



Polished

ANTWERP

The general feedback in Antwerp is that polished is moving but not at the prices people need. The imbalance between rough and polished prices has resulted in a gap of 4 to 5% on average. Antwerp has become a tough, competitive trading centre; Indian companies report they can fetch 2 to 3% more for the same polished in India, especially in larger (1ct up) and small size (-20pts) polished.

For most traders, demand levels remain rather conservative and are not where they should be for this time of the year. Emphasis of activity at the moment is in clean quality melee and down, while larger goods (5/4/3 per ct and up) are slow, except for VS-SI quality which is moving well. The balance of the goods does move but only at the right price. Pique (I1 lower) in any size and any colour is reported to be strong. Traders are waiting for Rapaport to increase its price list.

People report growing polished inventories in the pipeline, however this has not reached an uncomfortable level yet; a situation which will change it if/when rough prices drop. Liquidity does not seem an issue yet as there is enough access to credit.

TEL-AVIV

While September was a relatively quiet month full of Jewish holidays, sales in October are nothing to complain about. There is regular demand from the USA and from India and to a lesser extent from HK/China. Europe continues to languish. There is approximately 2 weeks left to the season, afterwards demand will be mainly 'plugging holes'.

While sales are relatively good - it is after all peak season - profitability is a serious issue. While polished prices increased month after month during the first six months of the year, the last few months (since July) have been essentially flat.

The Hong Kong show in September was considered moderately successful with sales okay but margins tight or non-existent. This is not surprising with billions of dollars of polished chasing perhaps a few hundred million dollars of demand.

A number of Israelis have flown recently to Mumbai to look for cheap polished. For the moment they are finding it difficult to find 'distress sales'. Indian manufacturers have paid dearly for the rough, have overheads, and are naturally looking to make a profit.



MUMBAI

With the stock market reaching new heights, much of the property market reaching 2008 prices, and a strong rupee, the mood in the Indian market is generally optimistic, the perfect environment for the opening of the Bharat Diamond Bourse.

Polished trading is more frequently taking place in rupees instead of dollars due to currency volatility, and several large businesses are available for purchase as India becomes a popular marketing destination for polished stock from countries like USA and Japan.

Stars remain consistent in demand due to lack of production. Prices have gone up 3%. 0.23 – 0.29 cts is moving well in I1 clarity and down as well as in the better qualities.

NEW YORK

Throughout the year there has been a feeling that this Fall would see some bankruptcies but so far that has not been the case. In fact, overall the mood is reasonable because the US economy is seeing a gentle recovery – one which most believe is sustainable.

Most people don't think that buying for the season has yet hit its stride. Normally sales would have warmed up but that doesn't yet appear to be the case. It may be that more buying is going on abroad although that would only be the case for the majors. However, the market is witnessing a higher proportion of goods sold versus placed on memo than has been the case in the past. Market expectations for the season are broadly in line with DTC's prediction during sight week: up 2-4%.

Goods in H-I colour, SI quality up to 3cts are in good demand. D colour goods are also seeing good demand, but E and F colours are particularly weak.

HONG KONG

We are now a few weeks after one of the main sales events of the year and there were no real surprises. On the negative side, one could say that three shows at almost the same time (Shenzhen, Asia World Expo and Wan Chai) is a bit much, and that with so many goods around, price has become the only possible differentiator. Local Chinese turnout was not particularly big and a lot of overseas companies take this as a buying opportunity. On the positive side, people held on to polished prices and resisted price pressure quite well. Furthermore it seems that Hong Kong is gaining momentum as a trading platform and gateway to the rest of Asia and Asia Pacific, with increased volumes of polished going through this region.

Hong Kong jewellery and watch retail sales in August rose 29.6% compared to the same month last year. Retail sales in general, reflected healthy growth since domestic consumption remained vibrant in the post-financial crisis era. It was also bolstered by the increasing number of tourists and steady employment environment.

Hengdeli Holdings Ltd., the largest luxury goods retailer and wholesaler in the PRC with its primary focus on middle-to-high end luxury watches, plans to sell HK \$2.5bn of convertible bonds to fuel expansion. The company intends to open 50 outlets, bringing the total number of stores to 320 across China, HK and Taiwan.

On October 6, Sotheby's held its biggest auction ever for jewels and jadeite, reaching US\$ 54m in sales. The auction also achieved the highest per-carat price for any round white diamond when it sold a matched pair of 10.88ct D-flawless for \$ 221,649 per carat



Retail

EUROPE

There is a general pick up in jewellery orders in Europe; this is partly seasonal but also supported by a strengthening € which has given retailers renewed confidence to stock up merchandise for the main selling season. Jewellery orders collected are mainly for items €500 up slightly higher price points typical for a Christmas offer. Retailers show in general positive sentiment as they (finally) want to start to make some profit. Jewellery manufacturers continue to face price and margin pressure due to (record) high gold and soaring diamond prices.

Italy is quite active at the moment, Germany has been reported as being busy. Orders from Swiss and other luxury brands remain strong and prices are firm. As requirements continue to be specific, supply shortages are reported.

The Swatch group has announced it will introduce Omega jewellery in India by early next year. Swatch is also working on strengthening its presence in the country by expanding its retail reach. The group is also planning to build new factories in different parts of Switzerland and to expand its workforce; the company is convinced that the watch-making industry will grow in 2011 by possibly 5 to 10%. According to the company, the Swatch brand would achieve a turnover of CHF 1bn in 2011 and other brands within the group - Longines, Tissot and Breguet – should be close to the same result. Swatch Group opened recently its 29th airport outlet in the International Terminal at Dusseldorf Airport.

Tag Heuer intends to open 15 showrooms in India in the coming 3 years up from 6 today for an estimated €17m. The market remains largely centred around large cities (Mumbai and New Dehli) but enjoys strong momentum as the number of High Net Worth Individuals in India increased by 51% (from 84 last year to 127000 individuals this year), according to the company.

LVMH expects a solid 2H supported by an improving economic backdrop and tourism offshore consumption. The company expects revenues in Asia, Europe and the US to remain solid for the rest of the year and reiterated the group's focus on organic growth. Analysts expect 15% reported growth in 2010. Taking into account the currency impact, this would imply about 8% organic growth for LVMH in the 2H, down from a 14% increase in 1H 2010. Louis Vuitton recently raised its prices in Europe by as much as 9% on certain products.

USA


An uneventful month on the announcements front.

Michael Hill International's sales in the US dropped 27% compared to the same period last year, due to eight stores closing during that time. However, same store sales increased by the same amount. Its Canadian sales during the first financial quarter rose 26% with same store sales up 23%.

Fourth quarter sales were down 3.4%, with same store sales down just over 2% at **Zale Corp.** The company made a loss of \$28.5m during the period, which was a significant improvement on 2009.

HONG KONG AND CHINA

The Chinese retail landscape continues to expand, with at least 500 new diamond and jewellery retail stores opening every year. China now represents about 8% of the global DJ retail market, which represents probably \$2.2b - 2.5b at wholesale value.



Main growth now comes from developing Tier 3 cities; Tier 1 being Beijing, Shanghai and Guangzhou, Tier 2 all Provincial capitals. Most retailers continue on the expansion path and several seem to be working towards an IPO. CHJ jewellery recently made the news, Shanxi based retailer CC Jewelry Ltd. recently announced its plans of an IPO and others will no doubt follow.

One sometimes wonders whether this has become a target in itself and whether these chains with vast numbers of stores are still manageable, let alone profitable. Competition is fierce and China's e-commerce continues to grow.

China's single, middle-class consumers, between the ages of 20-44, comprise the largest group of on-line shoppers. Cosmetics and jewellery are cited second of items that they often buy on-line. Some retailers estimate that products sold via on-line shopping may be up to 50% cheaper than those sold in traditional outlets but then these businesses are running on very low overheads. Indeed, established retailers such as Hiersum now also plan to make their product available on-line and reduce the number of points of sale.

Because consumers shop with a certain budget and because they are keen to buy larger diamonds, they are forced to downgrade in colour and quality. This phenomenon is interesting as it opens up the range of polished to include lower qualities as well. It makes China even more interesting as a diamond jewellery retail market.

Just as the Chinese government is concerned with sustainability of growth for the economy by for instance ordering banks to curb lending and increase the amount of money they hold, also our industry should be careful about exposure and bottom line.

INDIA

Domestic retail is hitting its stride with most of the companies expanding into loose sales. With Diwali just around the corner and retailers stocking up for the marriage season, polished in all ranges is moving very well. Pique is moving faster than quality goods but with smaller margins.

Several retailers and wholesalers to tier 1 and tier 2 cities have posted considerable sales growth in September, some up 10%. Moreover, with the rupee firming against the dollar, gold prices are likely to get capped, thereby further boosting demand for jewellery.

After low-key activity of the past few months, the retail industry is looking forward to a good season.



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