

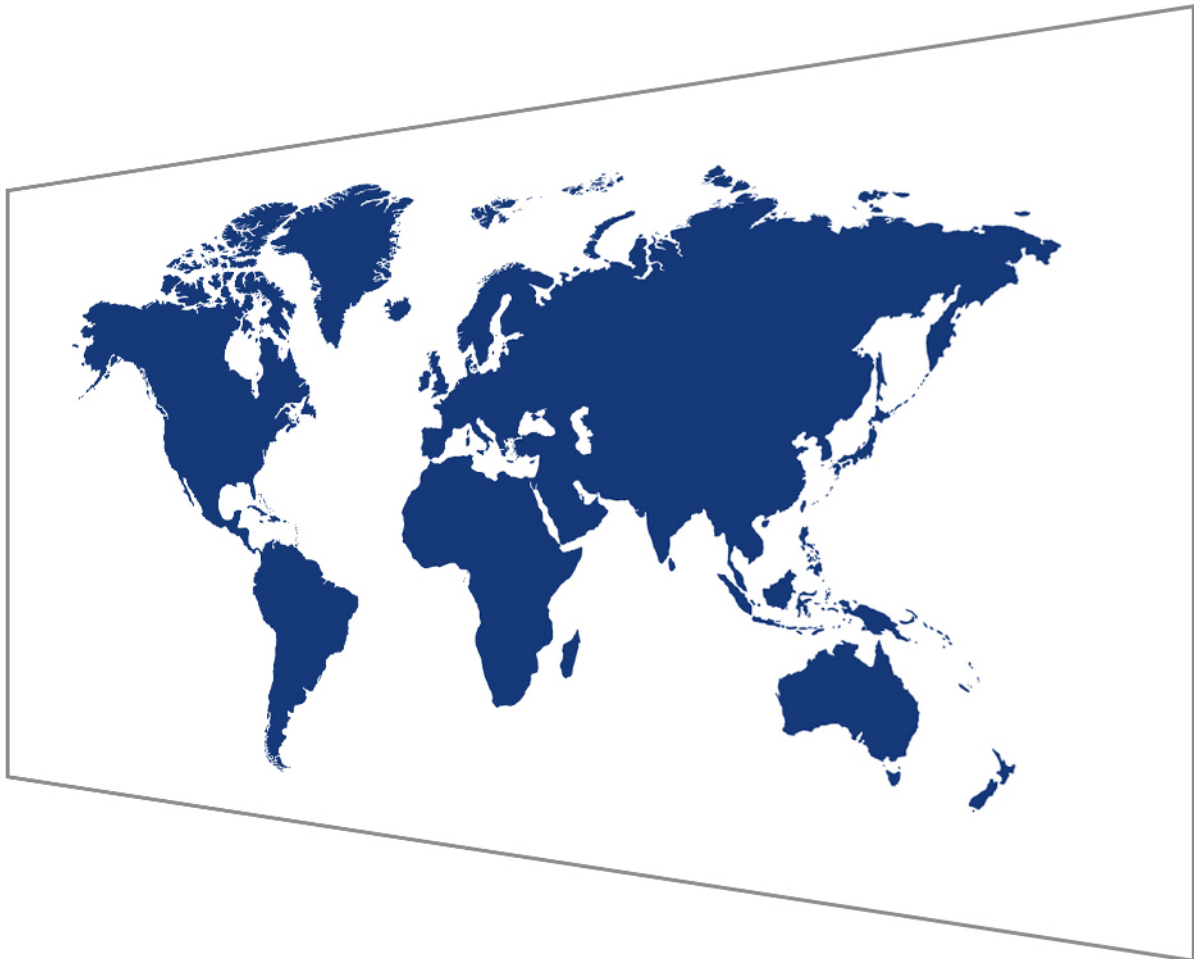


Bonas

Diamond Brokers & Consultants

Market Report

September 2011





Rough

GENERAL COMMENT

The rough market merry-go-round has certainly come to an abrupt halt as the liquidity crunch, summer price rises and slower polished sales coincide. As is often the case, the market changed direction faster than many expected. Suddenly large swathes of the rough available are cheaper than DTC but would-be buyers remain very hesitant. As usual, eyes fix on a target in the near distance, in this case the Hong Kong show – hopes are that polished prices will hold up, but the combination of large stocks being shipped there, liquidity worries and luke-warm polished demand suggest different outcomes. It does look as if we may be in for a sticky autumn, but the internal logic of the diamond sector points to better things in 2012 – the dangerous unknown is what will happen in the wider economic world between now and December.

ANTWERP

The reduced appetite for rough and the fading market premiums, which we reported at the end of July, are even truer today. Over the summer holidays, market sentiment deteriorated further, probably strengthened by turmoil on the world's financial markets.

A correction was to be expected, and although relatively small in volume, the BHP spot sale has drawn people's attention as it is perceived to be a true reflection of secondary market sentiment. According to tender participants BHP's total sales were down by just under 40% to total about \$90m. The decline in carats was about 20%, also because a number of items were withdrawn. Prices on paper of +2cts were down by some 20% and the -2cts were down by nearly 30%, with especially Rejections and run of mine down a lot.

At the DTC sight most sightholders were surprised that prices were raised even a little in the light of the turbulent summer we had. Even more so as the July increase – which was much more substantial – had not been absorbed yet in polished, simply because there had been very limited polished activity. Premiums on boxes quickly dropped into negative territory and that trend became stronger as the week progressed. On average, premiums (discounts) settled at around L-5%.

Russian goods have reportedly not changed in price, but Angola goods can be found at prices 20-25% cheaper.

All this is happening in a market with fewer buyers around. There are several reasons for that:

1. We believe that quantity of first hand rough sold so far this year has reached record levels (\$14bn?). We estimate that maybe a quarter of that has never been put into manufacturing and still sits in safes.
2. In carat terms, we are not breaking new records, but it's the dollars that make this business tick. The rough and polished trading activity of the first 8 months has soaked up a lot of liquidity, which is not a problem as long as fresh money comes from the retail side. We believe this has not happened enough, certainly not enough to absorb the total rough input.
3. Resistance to polished prices has also strengthened, and with news travelling fast, retailers see the change in rough and expect similar corrections in polished. Were that to happen, it would severely affect the manufacturing business.



MUMBAI / SURAT

August marked the end of three consecutive quarters of growth in the Indian diamond market with confidence taking a sudden and steep dip. Bank loan utilization has spiked in the last few months, inventories in both polished and rough are said to be higher right now in dollar terms than when the market turned in 2008, and inter-trade business has almost come to a halt. The slowdown in polished that coincided with rough was not expected and is causing deep concern. Expectations of large amounts of Zimbabwe goods entering the market continue to erode both rough and polished prices.

Given the swollen inventories, both traders and manufacturers are hoping that the following sight is a smaller one. A majority of DTC boxes have been sold below list, and at 60-120 days, and boxes from other miners are moving in a similar fashion. August results of BHP are further proof of full inventories. Those buying in cash are pressing for significant discounts. Overall rough prices are down by 20-25%, with discounts deepening in the week after sight. The choppiness seen in trading is reflected at manufacturer level. Manufacturing is at an estimated 60% capacity. 20% of smaller players (10-15 wheels) have closed down and they prefer to sell discounted rough at this stage for liquidity.

OTHER INDIAN MANUFACTURING CENTRES

Almost all other units are operating at 40% (less than in Surat). Add to this the various holidays in India, and the result is a serious build-up of bruted or unfinished polished stones. If the market doesn't pick up after Diwali, there will likely be further cutbacks of 20%. The Argyle team is now targeting small villages, along with Ahmedabad and Bhavnagar, to boost the usage of their rough. They have deployed technicians in a couple of units in each centre and are giving know-how on polishing Argyle rough. The situation in Bhavnagar is the same as the previous sight, with the exception of production which lies at between 45-50% of capacity.

TEL-AVIV

The increase in rough prices during July, and the summer vacation quickly brought the optimism and positive atmosphere in the Israeli diamond market to a halt.

Other factors have obviously also contributed to the change of direction, such as the economic situation in Europe and the United States, volatility in the stock market, talk and perception of a very large sight, the change in Indian market sentiment, and a fall of 5-10% in polished prices.

The reaction seen at this sight was expected but the speed at which it arrived following the peak was not. However, it was obvious that prices could not continue rising at that pace indefinitely.

The current situation clearly illustrates the benefit of the sight and ITO system, and the need for balanced distribution between the various global centres.

The rumours and the talk of trading of boxes discounted between -8% and -10% turned out to be exaggerated, and trade was conducted between L+2% and L-6%, depending on the article, the pressure the seller was under, and when the deal was closed.



NEW YORK

The rough market is incredibly unsettled by the sharp drop in BHP's tendered rough prices and the losses being quoted on DTC boxes. That said, although a few boxes have been sold at a loss, there hasn't been that much trading occurring. There have been some Canadian goods on the market, but these are considered very expensive and have not even been looked at.

SOUTHERN AFRICA

Ahead of the sight, clients in South Africa were excited with the ex-plan (additional goods) offered. However news from the market that there is already rough oversupply and that rough prices from the tenders are negative resulted in a bit of unease on the part of some clients. Manufacturing clients remain hopeful that diamond prices will hold.

The deliveries in Namibia remain uncertain, as evidenced by the allocation shortfalls, due to the on-going strike.



Polished

ANTWERP

There is little polished business taking place in Antwerp, mainly due to two reasons: 1) The Antwerp market hasn't really re-started yet 2) Buyers wait and watch at the moment. Traders report there is demand, however buyers are mainly inquiring about prices, not really placing orders (yet). There is a pervasive feeling of uncertainty; the price corrections in rough and RAP have had a psychological impact on polished buyers and sellers. No one knows the price of polished today; this lack of benchmark has paralysed the market completely. Whatever business there is, it is selective and at prices which have softened minimum 5 to 10% compared to pre-holidays.

All eyes are now on the Hong Kong show of mid-September. Traders have moderate expectations, saying one should be happy if at least some volume can be maintained.

- Continued demand for stars, especially the top end
- Due to Mr. Rapaport's price adjustment on round-edge fancies, well made stones may have good value

TEL-AVIV

Most of the market is currently in 'wait and see' mode: wholesalers certainly are, as are buyers from HK/China. People are waiting to see whether rough market prices will fall further and how the Hong Kong show will play out. Nobody wants to buy expensive, nor buy for stock. There are however some orders coming in from all regions, particularly American retailers who haven't yet received the "instruction" to stop buying.

It seems there are two schools of thought in the market: the 'doom and gloom' camp believe prices are still on the way down and there is a long way to go due to the troubled economy and a pipeline perceived to be relatively full. The other believes the fundamentals of the market are still healthy and the market is experiencing a necessary correction, but prices are



not likely to go down more than another 5-10%. Take your pick.

- 1-2 ct certificate prices are down 5-10%.
- Demand and prices for fancies is stable.

MUMBAI

The IJJS fair failed to instill confidence in diamantaires, and diamond jewellery manufacturers who were kept busy during the fair have been unable to convert the interest into sales. Indian retailers are taking a wait and watch position to place orders, and those who were open-to-buy during that time are also postponing international buyers too are refraining from making anything other than urgent purchases.

- 0.10 – 2 cts moving slowly with pressure on prices.
- Reasonable movement in browns and fancies.

NEW YORK

The positive news is that US retailers are still placing orders and that retail sales are still ahead of expectations despite the economic turbulence. However, over the last 10 days retailers' attitudes have changed. They have become very aggressive on pricing, with the majority asking for a discount of 10% and walking away if it is not given.

Order sizes are also being cut – not because of poor demand – but purely because of the uncertainty on the movement of prices. The sudden switch from a seller's market to a buyer's one has been quite dramatic.

The market is looking at the Hong Kong show as an indicator of how business will pan out for the rest of the year. Optimism for a strong show is not high with most feeling that it will be fairly lackluster. That said, whilst the market is nervous now people do not feel that this is the beginning of a 2008 rout but that a small correction is underway, and that stability should return at the start of 2012.

- Demand and prices for +5 cts has not dropped to the same extent as 1-2 cts.
- Sharp drop in demand for 1-2 cts VVS clarity as this is considered too expensive. Still movement in VS-I clarity however ~10% off peak prices.

HONG KONG

The recent nervousness on the rough trading markets and the downward changes on the Rapaport price list have slowed down the polished trading business in Hong Kong. Already there was more price resistance in July and big price differences existed between traders. Those wanting to buy prefer to await the September show because goods will be abundantly available in what is expected to be a buyer's market.

Goods that increased most in the first half, now are taking the biggest beating: prices on dossiers are down by 8%, whilst prices of parcels of similar goods seem to be holding better. Also the prices of 4 grs have dropped by about 10%. Jewellery retailer Chow Tai Fook Jewellery Co on Wednesday submitted the so-called A1 from with the stock exchange, the first formal step in an IPO that could raise \$3-4bn. The company plans to list in December.

Shares of Hong Kong-listed jewellery store operators Luk Fook Holdings International Ltd. and Chow Sang Sang Holdings International Ltd. have risen more than 40% so far this year.

- Slowdown in 4grs and 0.90ct with increasing price resistance
- Good demand for 3grs/0.80ct
- 0.30-0.50 ct: demand mainly for non-certified parcels
- 5pc moving, 4pc less so



Retail

EUROPE

Retail markets are caught up in uncertainty at the moment; high gold prices combined with dropping polished prices make buyers reluctant to purchase. The low-end of the market is reported to perform at a very slow pace; the record gold price makes it near impossible to reach the price points of this segment. The mid-market is struggling with a fall in unit sales, while high-end is described as stable. Germany seems to be ok, Italy is problematic. The rest of Europe is described as slow.

Demand from Swiss and French luxury brands remains intact at the moment, although some part is pipeline filling, driven by expansion plans. Swiss watch brands saw continued strong demand in July, but analysts estimate growth to slow in 2H 2011 as a result of the stock-market downturn, which is likely to hit bonuses and investors' portfolios. Exports of Swiss watches totaled CHF1.7bn (\$2.16bn) in July, up 22.7% from a year earlier. Watches wholesaling CHF 3000+ posted the strongest performance, up more than 25% both in value and volume. Exports are expected to slow down to single digit growth figures for the rest of year (overall estimated increase of 15% for the whole of 2011). This slowdown in demand toward the end of the year could lead to an inventory problem, whereby retailers are carrying too much stock. According to Swatch, falling stock markets could help boost sales as people prefer to invest in something that keeps its value.

Watchmakers have increased their prices (an estimated 5 to 10%) to protect profit margins as the franc climbed to record levels against the € and the \$. Further price rises are expected. As it is already the second round, it is likely that it will have an impact on demand.

USA

Signet: 2nd quarter of the financial year saw sales of \$797.6m, up 10.8% on the same period last year. Same-store sales were up 9.9%.

Sales in the US saw sales increase 11.3% increase and same-store sales rise by 12.2%. In the U.K. sales were up 8.8%,

Same-store sales up 1.4% but flat when exchange rate fluctuations were taken into account.

Zale Corp: Q4 sales were up 9.4% compared to the same period last year, with same-store sales increasing 9.8% (8.5% at constant exchange rates). The full year 2011 results showed sales at \$1.7bn, an increase of 7.9% on 2010. Same-store sales for the financial year increased 8.1% (7.1% at constant exchange rates).

US DEPARTMENT STORES

Saks: 2nd quarter sales increased 13% on the same period last year and same-store sales increased almost 16%. However, jewellery was not a category on the best-performing list.

INTERNATIONAL BRANDS & RETAILERS

Tiffany & Co.: 2nd quarter sales increased 30% on the previous year to \$872.7m. Same-store sales were up 22%. In the US, sales were up 25% for the quarter, with same-store sales up 23%. Asia-Pacific sales were up 55% (45% on constant-exchange rate basis), Japan up 21% (8% on constant exchange rate basis), and Europe up 32% (17% on constant exchange rate basis). Michael Hill International's full year results for 2011 saw total revenue increase 10% year-on-year to \$406m (NZD 489.3m). Same-store sales increased 9.2%. For the full year, in New Zealand sales increased 6.2% and same-store sales increased 5.4%; in Australia sales increased 6.2% and same-store sales increased 2.2%; in Canada sales increased 22.7% and same-store sales increased 12.1%. The US saw sales fall 24% but same store sales increase 20%.



ONLINE RETAILERS

Blue Nile's net 2nd quarter sales increased 5.1% compared to the same period last year. Bidz.com's second quarter sales fell 23%. Sales for the 1st half also fell by 17%.

HONG KONG AND CHINA

The retail business is ready for a pick-up in September – October. Most retailers report solid double digit growth on a like for like basis and most remain optimistic for the months to come. The central government's control on credit to curb inflation, could however negatively impact on consumer spending.

Growth is attributed to the continuous fast pace of growth in retail outlets in second and third tier cities, the steady growth maintained by the coastal first tier developed cities, and the rapid growth in Hong Kong.

Hong Kong's sales of luxury goods including jewellery and watches grew 37 percent year-on-year in terms of volume during July, according to government statistics.

Strong domestic demand helped Chinese manufacturing growth record a marginal increase in August, despite a sharp fall in export demand. Input prices are rising and growing cost pressures could put many more small-to- medium size manufacturers out of business, and are likely to be passed on to consumers. Analysts believe that the rebound in output and employment however, confirm the view that China will only see growth moderation in the coming months, rather than a hard landing.

Meanwhile, Fitch Ratings Inc. again warned of significant risks to China's banking system over the next few years, saying the property market poses the biggest threat. Credit risk has risen as a result of heavy lending to local governments and property firms. While the central government has initiated measures to cool property prices, including higher mortgage rates and curbs on purchases of second homes, housing prices remain high in big cities, including Shanghai, Beijing and Shenzhen.

INDIA

Large domestic retailers have done good business with year-on-year sales up by 20-25% in value, but volume wise it is up only by 5%. Small jewellery stores are still struggling to price their jewellery as gold has shot up and diamond prices have been volatile throughout the month. The 8-10% drop in price of polished in one month and on-going weakening in rough, means jewellers and retailers expect the polished prices to undergo further correction. They are happy to see a price correction as this will help them stabilize jewellery prices.



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