

Basic Materials

Perspectives on the diamond industry

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Introduction

Are diamonds really forever? With limited publicly available data, it can be difficult for analysts and executives to get a robust sense of the outlook for the diamond industry. And with major changes taking place across all parts of the value chain, from mining operations to consumer buying patterns, it can be hard to assess what the future might hold.

McKinsey believes that the diamond industry will remain attractive to investors, but we also know that companies across the value chain are looking for insights to help guide their long-term strategy development. We have, therefore, analysed a series of potential scenarios for the industry over the next ten years, looking at a range of variables and their potential impacts on different parts of the value chain. Our scenario-based assessment offers an independent perspective on the drivers of industry performance, based on proprietary research and insights from the McKinsey Global Institute (MGI), the business and economics research arm of McKinsey.

Our analysis suggests that even under the most pessimistic demand scenario and the most aggressive supply scenario, the fundamentals of the industry will likely be positive, with demand outpacing supply growth. At the same time, the industry is set for rapid change under any scenario as a result of various trends, such as the expected accelerated or further increase in mining costs, the pressure on the midstream to professionalise and the continued shift in demand to emerging markets. Companies will need to position themselves carefully to take advantage of growth opportunities.



Methodology

This report begins by laying out *seven "fundamental trends"*: developments that are shaping the diamond industry today and are expected to continue to do so in future. These are:

1. Plateauing levels of production for the next ten years
2. Pressure from producing countries to extract more value
3. Increase in mining costs
4. Shift in demand to emerging markets
5. Changing consumer preferences
6. Increases in transparency and vertical integration
7. Improvement of technical capabilities in synthetic gems.

We then identified four uncertainties, which will likely have major implications for the future of the industry, and assessed their potential impact on players across the value chain. These four uncertainties are:

1. The global macroeconomic outlook
2. The future of retail consolidation and branding
3. Potential changes in consumer attitudes about diamonds
4. Potential new sources of diamonds (including recycling).

These uncertainties form the basis of the four distinct scenarios that are described in this report.

The report concludes with a perspective on three low-probability but, potentially, high-impact shocks that could fundamentally transform the industry if they were to occur. These are not integrated into our scenarios, but they represent "black-swan" events that are worth keeping in mind for anyone analysing or operating within the industry. They are:

1. *An extreme shock to demand* – if consumers' perception of the attractiveness of diamonds changes radically
2. *An economic derailment in India and China* – if these major emerging economies experience some form of societal or economic disruption that increases in severity, creating instability and movement away from the market economy
3. *Resource nationalisation in major producing countries* – if one or several major producing countries were to nationalise some or all production from their mines.

Our scenario modelling drew upon macroeconomic insights from the McKinsey Global Institute, which regularly publishes reports on the global macroeconomic outlook and possible variations thereof. We also incorporated other proprietary jewellery industry insights, such as our February 2014 report "Jewellery 2020 – On the Heels of Apparel", which provides insights into how the jewellery industry may develop based on industry and academic research, and approximately 20 interviews with the industry's top level executive experts. Finally, we interviewed McKinsey's internal experts across the value chain and external equity analysts on their views about the future of the diamond industry.

Seven fundamental trends shaping the diamond industry

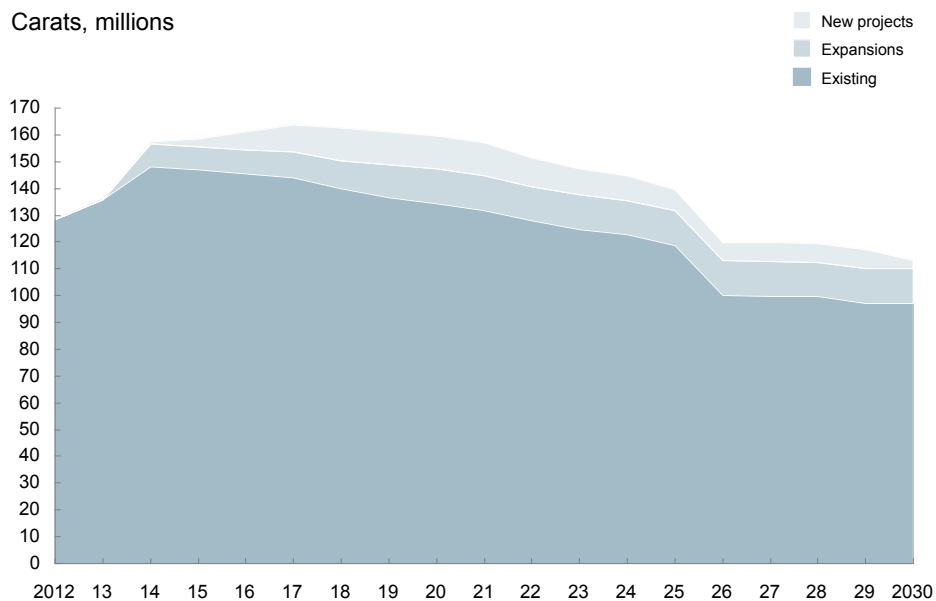
We have identified seven fundamental trends facing the diamond industry that will shape its future. These trends affect players from across the value chain and will likely remain constant, regardless of other less certain factors, such as the global macroeconomic outlook. This section describes each trend in turn:

1. Plateauing levels of production for the next ten years

In 2013 global rough diamond production amounted to over 136 million carats. Given the lack of recent, economically viable discoveries, rough production is likely to remain relatively constant over the next ten years. Post 2025, when a number of mines are scheduled to go out of production, production will start to decline.

EXHIBIT 1

Rough carat production will likely remain at approximately the same level for the next 10 years before gradually starting to decline



SOURCE: McKinsey proprietary diamond sector research

The last major diamond deposit discovery was Bunder in India, discovered by Rio Tinto in 2004. This case is illustrative of the time it takes to develop a mine because Bunder's deposits have still not been developed. Similarly, Gahcho Kué in Canada, which was discovered in 1995, indicates that 2015 to 2016 is the earliest it could enter into production.¹ Thus, we are assuming that any future discoveries will take just as long to develop; even a new, major discovery would be unlikely to come on-stream in the next decade and, thus, would only impact global production from the mid-2020s on.

2. Pressure from producing countries to extract more value

Across the world, resource-driven countries are keen to extract more value from their natural resources, either through increased taxes and royalties or through a strengthened

¹ Company websites.

push to increase their share of added value.² We expect this pressure to continue – in particular, in major diamond-producing countries in southern Africa (including Botswana, Namibia and South Africa), given their relatively low levels of economic diversification.

3. Increase in mining costs

New diamond deposits are found deeper underground and in less accessible areas, and it is, therefore, more complex and expensive to extract them. Thus, we expect mining costs to continue to rise across both capex and opex. Over the last ten years, the capital intensity of new projects has risen threefold across most minerals, and critical input factors, such as labour and energy costs have also grown rapidly. We expect cost increases in the future to outpace inflation, leading to rising costs per carat.

2 Examples include the new Petroleum Industry Bill in Nigeria, South Africa's ongoing debate about mine nationalisation, Zambia's recent restrictions on exports of emeralds and increased royalties on copper in Chile.

3 McKinsey, "Meet the Chinese Consumer of 2020", March 2012.

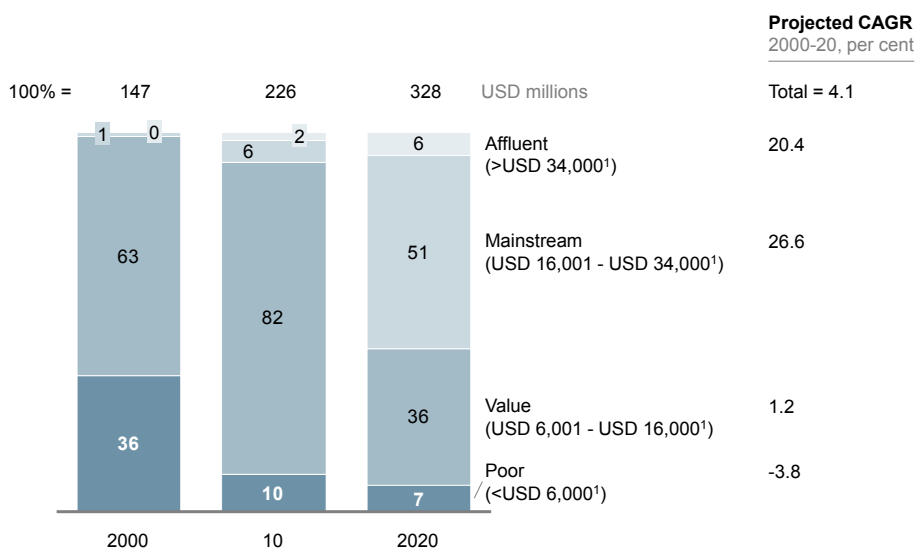
4. Shift in demand to emerging markets

Strong economic growth in developing markets continues to create a wealthy "new middle class", which will be an important driver of demand for diamonds. All of the five equity analysts we interviewed for this research identified the middle classes in Asia as key drivers of future demand. They specified India and especially China as particularly important to demand growth. McKinsey's own estimates³ indicate that by 2020 "mainstream" Chinese consumers – households with annual disposable income between USD 16,000 and 34,000 – will make up 51 per cent of urban households (from six per cent in 2010), and affluent households six per cent (from two per cent in 2010).

EXHIBIT 2

The number of affluent, Chinese, urban households is growing rapidly

Share of urban households by annual household income, per cent



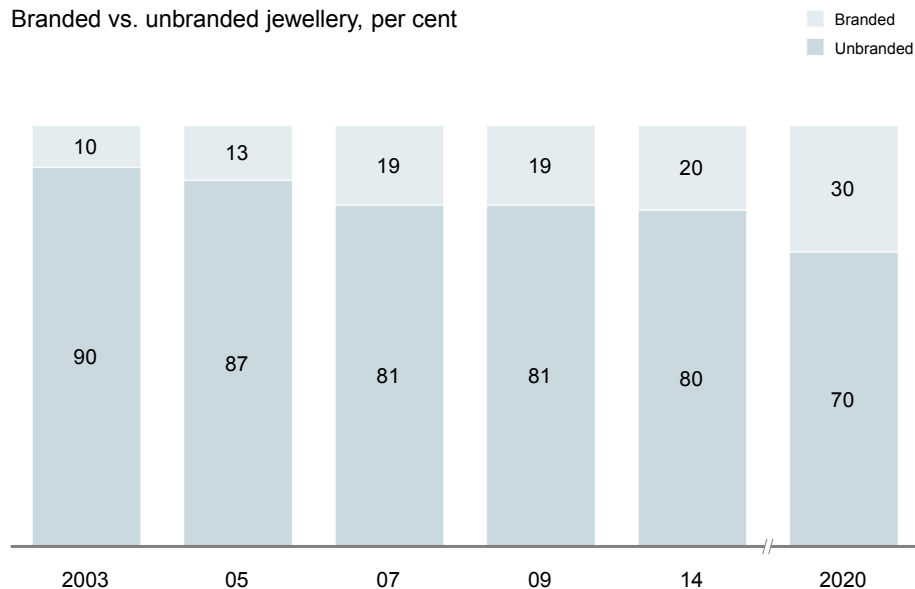
1 In real 2010 USD; in 2010, USD 1 = CNY 6.73
 SOURCE: McKinsey & Company, "Meet the Chinese Consumer of 2020", March 2012

5. Changing consumer preferences

Research undertaken for our Jewelry 2020 – On the Heels of Apparel report indicates that consumers increasingly prefer branded jewellery. This is also true for high-end diamond jewellery. Brands reduce consumers' risk of making the "wrong" purchasing choice and help them express their personality by way of association. Only 20 per cent of today's jewellery market is driven by brands. All the senior jewellery executives we interviewed for the report agreed that brands will claim a higher share of the market by 2020, although their views differed on how exactly that would happen. Most of them expect the branded segment to account for 30 to 40 per cent of the total market in 2020.

EXHIBIT 3

Preference for branded jewellery is increasing



SOURCE: McKinsey & Company, "Jewellery 2020 – On the Heels of Apparel", April 2013

Four factors underlie this trend. First, our research suggested "new-money" consumers (who are less likely than the "old-money" wealthy to have inherited jewellery) will likely seek branded jewellery to show their wealth. Second, emerging market consumers trust brands more. In our research, 80 per cent of interviewees quoted established brands inspiring trust and providing a lifestyle benefit as a purchasing factor. Third, interviewees highlighted the focus of many young customers on brands as a means of self-expression and self-realisation. Finally, luxury brands playing in neighbouring categories, such as Louis Vuitton, Hermès and Dior, are introducing jewellery collections or expanding their assortment, especially in the higher-end segment.⁴ For diamond mining companies, the impact of this is mixed. On one hand, it increases the likelihood that value will be captured by those who control the brand, as opposed to those who control the product (consumers will want "a Tiffany ring" rather than "a diamond ring"). But on the other hand, large-scale consumer brands have the means and ability to invest in building consumer demand for the product, which is the key to maintaining the position of diamond jewellery relative to other luxury goods categories.

⁴ McKinsey & Company, "Jewellery 2020 – On the Heels of Apparel", April 2013, pages 8-9.

6. Increases in transparency and vertical integration

Digitalisation of the supply chain will enable a larger client base to access the diamond market. A notable example is the development of online open auctions, which allow new players, not just the traditional select set of diamond buyers, to access rough diamonds. New technologies will also enable diamond jewellery manufacturers to be increasingly selective regarding the production they acquire. For instance, it will likely become easier for them to ask for specific assortments or to compare available production across different mining companies.

7. Improvement of technical capabilities in synthetic gems

Synthetic gem companies and the technology they use are becoming increasingly sophisticated. If synthetic stones leak into the diamond value chain without being properly labelled as synthetic, they may pose a risk to the industry by undermining consumer confidence in the authenticity of what they are buying. However, detection technology used to identify synthetics has, so far, kept up with the technology used to produce them.



Four uncertainties that could define the future

The trends described above will very likely be part of any future scenario for the diamond industry. The range of possible futures is defined by other far less certain factors.

These factors will collectively determine whether the diamond industry flourishes or stagnates over the next ten years. We have combined different outcomes for each uncertainty to create a set of distinct scenarios for strategic planning. This section describes each uncertainty in more depth:

1. The global macroeconomic outlook

The first uncertainty to take into account is the global macroeconomic outlook. Historically, demand for diamonds has increased more or less in line with GDP growth. We expect this to continue in the future.

We have based our perspective on the macroeconomic outlook on work by the McKinsey Global Institute, selecting four of the most likely MGI scenarios with particular relevance to diamonds. The implications of these on core diamond-consuming markets are illustrated in Exhibit 6.

The four MGI scenarios we have drawn upon are:⁵

a. The Chimerican Decade. In this scenario, global growth is 3.2 per cent per annum until 2025. The United States and China remain the dominant economies, and the latter transitions to a much more balanced economy. Most other emerging economies stagnate. The eurozone gradually unwinds, not as a catastrophic collapse, but rather as a result of several years of intermittent financial crises, persistent imbalances among member countries and increasing social unrest.

b. The Leveling Decade. This scenario has set global growth at 3.2 per cent per annum until 2025. The United States and China weaken. The United States remains mired in long-term debt. China overreacts to the slowing of global demand and is forced to address the twin challenges of social unrest and a weakened financial system. Other emerging markets continue to grow, and the major economies re-engage on the topic of global trade and financial reform. Europe haltingly implements critical elements of a banking and fiscal union. Greece leaves the European Union in 2015, but other countries commit to a new round of integration.

c. Global Growth Renewed. In this scenario, global growth reaches four per cent per annum until 2025. The United States addresses long-term debt by restraining interest rates, even if recovery attracts more foreign investors. The economy also grows from a rebound in the housing and energy sectors. China slows down in the short term, but the government steadily reforms the banking system to bolster consumer credit and lay the foundation for the development of a broader financial sector. The Chinese government also explores options to loosen capital flow controls. Emerging markets contribute 68 per cent of growth to and represent 48 per cent of the world's economy by 2023. Developed markets return to an average growth of 2.2 per cent, similar to the pre-2000s crisis. A European recession is a catalyst for greater financial and fiscal integration of member countries.

d. Emerging Economies Lead. In this scenario, global growth is estimated at 3.3 per cent per annum until 2025. The United States does relatively well with just under two per cent

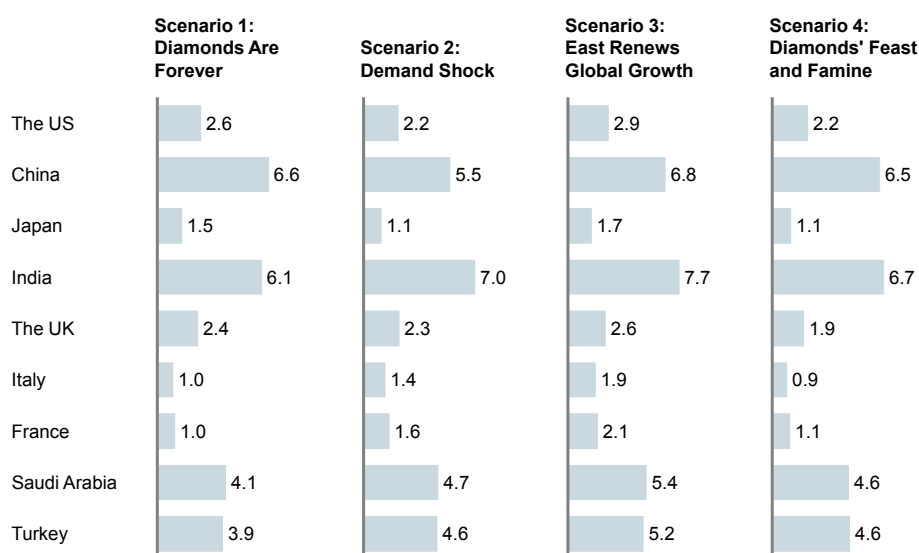
⁵ For more details, please see McKinsey Global Institute, "Uneven Recoveries and Diverging Prospects – Global Scenarios for the Next Decade", 2012.

growth thanks to expansion of both upstream and downstream energy industries and the related reduction in domestic energy costs. China shifts to a more consumer-oriented and service-oriented economy, introducing social reforms and considering the liberalisation of its capital account. Developed economies grow at 1.3 per cent per annum, and emerging economies grow at 5.9 per cent per annum in 2025. China, India and Brazil account for 40 per cent of global consumption growth, almost twice that of Europe, the United States and Japan combined. Advanced economies are increasingly vulnerable to downturns in periodic financial crises. Europe disintegrates and GDP across the continent recedes back to 2012 levels.

EXHIBIT 4

2013-25, per cent

Projected GDP growth for core diamond markets under 4 scenarios



SOURCE: MGI

2. The future of retail consolidation and branding

Retailers play an important role in influencing whether and how consumers buy diamonds. Their ability to invest in attracting consumers to the category (for instance, through branding) is determined by the health and scale of individual players in the market. A fragmented retail industry is unlikely to invest significantly in promoting diamond jewellery. A more consolidated industry would be more likely to see large players making substantial investments.

We expect organic consolidation to take place in the more depressed economic scenarios as some players go out of business and those who remain each represent a larger share of the market. In instances of improving economic conditions, undervalued players will become the target of bigger players, driving consolidation with mergers and acquisitions. An example of this trend is LVMH's purchase of Bulgari in July 2011.⁶ As the jewellery market becomes increasingly buoyant, however, we believe the rate of consolidation will slow down as acquisitions become too expensive.

5 <http://www.forbes.com/sites/hannahelliott/2011/03/07/lvmh-acquires-majority-stake-in-bulgari/>.

3. Potential changes in consumer attitudes about diamonds

Retailers can only attract consumers to the diamond jewellery category if consumers perceive diamonds as being inherently valuable and attractive and more desirable than other luxury goods. In traditional strongholds such as the United States, consumers have maintained a strong loyalty to diamonds thanks to years of marketing. The extent to which this continues will depend on how much the industry invests in marketing to ensure it remains relevant to consumers.

In emerging markets, as the market for luxury goods grows, the success of diamonds will depend on how much players are willing to invest to build a following in each local market – bearing in mind that some cultures already have strong associations with other precious metals and gems (such as the importance placed on gold jewellery in India).

4. Potential new sources of diamonds (including recycling)

Even under the most pessimistic demand scenario and the most aggressive supply scenario (including significant increases in recycling rates), analysis suggests the demand for diamonds will increase more quickly than supply. Depending on the rate of price increases, new diamond-producing mines will come online as and when individual projects become economically viable. Thus, there is some elasticity of supply, but the number of possible projects is limited unless major, new discoveries are made.

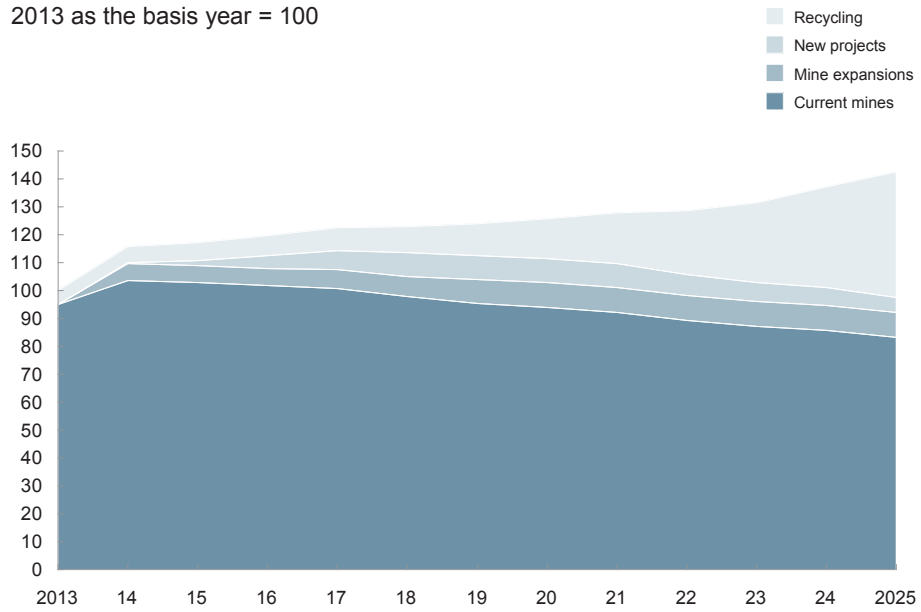
Production from mines currently on-stream is relatively well known for the next decade. We expect a number of additional projects to come online, including De Beers/Mountain Province Diamonds' Gahcho Kué, Alrosa's Botuobinskaya, Stornoway's Renard, Lukoil's Grib, Gem Diamond's Ghaghoo and DiamondCorp's Lace Project. The timing of these, and whether other more marginal projects actually happen, will depend on the overall buoyancy of the market.

Mine production of rough diamonds will also be complemented by recycled diamonds re-entering the value chain. Recycling of precious materials closely follows financial distress. Therefore, during times of financial stress, consumers may feel compelled to recycle their diamond jewellery, increasing the overall supply of diamonds.

EXHIBIT 5

Even under the most aggressive assumptions, recycling will likely only represent about 1/3 of supply by 2025

2013 as the basis year = 100



SOURCE: McKinsey diamond supply model



Future scenarios for the diamond industry

Given the large amount of uncertainty surrounding the future of the diamond industry, a set of scenarios is helpful to understand the span of potential outcomes and to pressure-test strategies for different players across the diamond industry. By combining the fundamental trends and uncertainties described above, we have created four potential strategic scenarios for the diamond industry. These are not exhaustive of all potential outcomes nor are they a predictor of what will happen, but they do provide a clearer view of some of the risks and opportunities that the sector may face. Our four scenarios are as follows:

1. Diamonds are Forever
2. Demand Shock
3. East Renews Global Growth
4. Diamonds' Feast and Famine.

Four scenarios for the diamond industry

Scenario 1: Diamonds are Forever

- Based on MGI case scenario “The Chimerican Decade”, global growth at 3.2% p.a. until 2025
- Strong demand is driven by China and the US; Japan and Europe have limited growth
- Additional supply takes place as buoyant market makes previously inactive mines economically profitable
- Natural diamonds maintain emotional equity, differentiated from other gems/luxury
- Retail consolidation continues on trend as market grows and margins are high, and brands continue to grow in importance

Scenario 2: Demand Shock

- Based on MGI case scenario “Leveling Decade”, global growth at 3.2% p.a. until 2025
- Although global growth is healthy, diamond demand is affected as the key markets struggle: the US is dragged down by long-term debt, and China is unable to drive domestic demand
- Retail remains relatively fragmented due to slower growth in key markets but with some consolidation from financial distress
- As companies reduce investment in brands and consumers move away from conspicuous consumption, diamonds lose some of their appeal
- Production remains stagnant but recycling picks up in stressed markets as consumers encounter financial distress



**Scenario 3:
East Renews Global Growth**

- Based on MGI case scenario “Global Growth Renewed”, global growth at 4% p.a. until 2025
- Growth driven by emerging markets, especially China and India; the US enjoys moderate growth and the rest of the developed world is stagnant
- Consumer base widens as emerging middle class grows, and these consumers buy into “the diamond dream” – albeit a version of the dream where brands are much more important
- In retail, China consolidates further and the Indian market consolidates much more as retailers build scale
- In developed markets, diamonds lose some of their magic, and recycling accelerates driven by financial distress
- Supply struggles to keep up with increasing demand in the East; risk of governments increasing taxation is high, thus, limited new capacity is brought online

**Scenario 4:
Diamonds’ Feast and Famine**

- Based on MGI case scenario “Emerging Economies Lead”, global growth at 3.3% p.a. until 2025
- The economy experiences high levels of volatility, and the diamond industry is very cyclical: strong increases in demand precede sharp decreases, leading to scattered supply expansion
- Lead time between the demand and supply cycles implies strong variations in prices
- Mining companies strive to diversify their mining assets to avoid cyclicality
- Midstream players consolidate around the most cost-effective players that are able to absorb cyclicality
- Consumers increasingly move away from diamonds to other less conspicuous categories of luxury goods, especially in China, and brands slow down investments
- Retail consolidation increases as players go out of business

Scenario 1: Diamonds are forever

In this scenario, consumer demand grows strongly, fuelled by the “double-cylinder” effect of a strongly recovered United States economy and continued growth in China. Brands become more important and increasingly invest in promoting the allure of diamonds. Even with demand in Europe and Japan softening, the dynamics of supply and demand in this scenario mean that previously inactive mines and new development projects will become economically profitable.

Macroeconomic assumptions

- Global growth remains at 3.2 per cent per annum until 2025.
- Strong economic growth exists in key diamond markets:
 - Chinese GDP grows at seven per cent from 2014 to 2025 and represents 16 per cent of global GDP in 2025.
 - The United States’ GDP increases three per cent from 2014 to 2025 and represents 21 per cent of global GDP in 2025.

Retail consolidation and branding

- Retail consolidation continues at its current pace. As the market grows, margins strengthen and brands continue to grow in importance. Consolidation is driven by a buoyant market, making jewellery an attractive category, rather than by retailers going out of business:
 - Luxury goods conglomerates see the opportunity in growing and acquiring profitable jewellery brands as a portfolio play.
 - As branded diamond jewellery boosts its consumer appeal, the larger investment required in marketing (brand building, retail network expansion) increasingly requires capital and scale that only large companies can provide.

Consumer attitudes about diamonds

- Diamonds remain highly relevant and attractive to consumers. Strong demand is driven by China and the United States; Japan and Europe see limited growth.
- Natural diamonds maintain their emotional equity, differentiated from other gems or luxury categories.
- China follows Western consumption patterns and branded diamonds take off by linking diamonds to love and commitment.

Supply of rough diamonds

- Additional supply comes online as the buoyant market makes previously marginal projects economically profitable.
- Recycling experiences moderate growth due to the professionalization of the retail channel, but volumes are not significant due to the overall lack of financial distress.



Potential implications for players in the value chain

- A larger share of consumers is educated to buy branded diamond jewellery and is steered to a limited number of large global (or regional) brands, especially at the top end.
- Retailers with scale are likely to win, as they will be able to invest much more in marketing and branding as well as in points of sale in Asia (in particular, China) and online.
- Cutters and polishers could trend towards consolidation as they feel increasingly squeezed: soaring demand will increase the price of rough diamonds, increasing the financing costs of the midstream even further.
- Two types of player will likely capture most of the value created: producers via the price increases of rough diamonds and retailers via the branding that will allow for diamond content to be a lesser percentage of sales.
- Diamond producers could face increasing challenges from more expensive and more complex exploration as existing supply struggles to meet increasing demand. While exploration for diamonds will remain challenging, the potential pay-off could also increase, and we could expect to see increasing investment in exploration both from major and smaller players.

Scenario 2: Demand shock

In this scenario, demand grows more slowly as key countries, such as the United States and China, experience weak growth. Companies lose the incentive to invest heavily in brands, and diamonds lose some appeal due to a lack of investment in promoting the diamond category and due to consumers moving away from conspicuous consumption. Production remains stagnant, but as consumers encounter financial distress, recycling increases to the highest level of any of the four scenarios.

Macroeconomic assumptions

- Global growth remains at 3.2 per cent per annum until 2025.
- GDPs in key diamond markets will grow:
 - At five per cent in China from 2014 to 2025, with Chinese GDP representing 14 per cent of global GDP in 2025.
 - At two per cent in the United States from 2014 to 2025, leading to the United States representing 20 per cent of global GDP in 2025.

Retail consolidation and branding

- Retail remains relatively fragmented. New consumers do not show a strong preference for brands, and growth is slow in already consolidated markets, for example, the United States and China.
- Diamond jewellery as a category does not outgrow GDP, and, therefore, large luxury players do not seek to merge with or acquire diamond jewellery retailers, as these targets are no longer attractive to them.
- Some degree of consolidation does take place, driven by retailers going out of business, especially due to slow inventory turns. This allows stronger retailers to gain share.

Consumer attitudes about diamonds

- Diamonds lose some of their appeal to consumers, as growth shifts from traditional strongholds, such as the United States, to consumers who are less anchored in diamonds as objects of desire and as developed markets struggle through tough economic times.
- Companies will need to invest in branding to build the diamond category in new markets, but such an effort will require time and considerable capital, which is less likely given financial pressures.
- Consumers in key markets will move away from conspicuous consumption during another downturn (especially in developed markets). Consumer behaviour is also affected by the increased likelihood of wealth and luxury goods taxation.

Supply of rough diamonds

- Production remains stagnant as fewer new projects are viable – the risk of increasing taxes and royalties is higher as growth slows and governments seek additional sources of income.
- Recycling picks up in developed markets as more consumers experience financial distress.

Potential implications for players in the value chain

- Diamond recycling could increase exponentially and become more professionalised, underpinned by consumers in financial distress.
- Given slower growth in demand markets, inventory turns could slow down. This would lead to a reduced demand for newly cut and polished diamonds, so the largest players would be the most likely to survive.
- Sales of rough carats would suffer as the demand shock is pushed down the value chain. This would likely be further accentuated by improved efficiency in cutting and polishing and recycling of pieces (either directly retailed or re-cut).
- As production stagnates and demand softens, certain mining projects will be delayed, and the risk of existing marginal production being turned increases as profitability is reduced.
- Funding for exploration would dry up as the industry outlook becomes uncertain.

Scenario 3: East renews global growth

In this scenario, the industry enjoys strong growth driven by emerging markets, especially China and India, with the United States enjoying moderate growth. The consumer base for diamonds widens as an emerging middle class grows and as consumers show a distinct preference for brands. In this scenario, diamond producers continue to invest in developing new supply projects.

Macroeconomic assumptions

- Global growth remains at four per cent per annum until 2025.
- Macroeconomic growth is driven by emerging markets. GDPs in key diamond markets grow:
 - At an average of seven per cent from 2014 to 2025 in China – Chinese GDP will represent 16 per cent of global GDP in 2025.
 - At an average of three per cent in the United States from 2014 to 2025, with the United States' GDP representing 20 per cent of global GDP in 2025.
- Emerging economies contribute 68 per cent of overall GDP growth and represent 48 per cent of the world's economy (up from 38 per cent today).
- The rest of the developed world grows at an average of 2.2 per cent annually (similar to the growth in the pre-crisis 2000s).

Retail consolidation and branding

- The Chinese market, which is already consolidated, grows in importance. Retailers in emerging markets become particularly attractive assets to acquire.
- In developed markets, consolidation is driven by retailers experiencing financial distress.
- Brands continue to be very important to consumers in China – and strong brands outperform the rest of the retail sector.

Consumer attitudes about diamonds

- Consumers show a strong preference for brands, especially in developing markets:
 - As the United States slows down, diamonds lose some of their magic for the American consumer.
 - As China remains strong, branding remains important.
- The growing middle class in emerging markets shows a strong desire for diamonds. Consumer middle class growth is driven by China: consumer spending as a share of global GDP from 2014 to 2025 increases by five per cent in China, representing 12 per cent in 2025. The United States' share of global consumption represents 25 per cent in 2025, declining one per cent from 2014.

Supply of rough diamonds

- Supply struggles to keep up with increasing demand from the East. Some additional capacity is brought on-stream, but increases in recycling offset some of the potential supply growth.
- Recycling increases in developed markets as consumers encounter financial distress.

Potential implications for players in the value chain

- The consumer base for diamonds will likely widen as the middle class grows in emerging markets.
- As the centre of gravity shifts eastwards, having the scale to build and expand a retail network in emerging markets as well as having the capabilities to operate in these markets will be critical for success.
- Retailers will have to increase investment in brands to appeal to brand-conscious Chinese consumers (who continue to drive global demand) and to foster desire for diamonds in new markets.
- Cutters and polishers might need to provide additional services to retailers or find ways to increase their value-added services, for example, by helping retailers sell better, becoming wholesalers or by being able to make special-cut stones, such as a heart.

Scenario 4: Diamonds' feast and famine

In this scenario, the diamond industry develops in a highly cyclical manner, driven by high levels of global macroeconomic volatility. Strong increases in demand followed by sharp decreases lead to scattered supply expansion. Lead time between the demand and supply cycles implies a wide variation in prices. Mining companies strive to diversify their mining assets to avoid cyclicalities and adapt to a growing trend in resource nationalism. Consumers increasingly move away from diamonds, and brands slow their investments.

Macroeconomic assumptions

- Global growth remains at 3.3 per cent per annum until 2025.
- The high cyclicalities of growth creates the most challenging conditions for the diamond market. GDPs in key diamond markets grow:
 - At six per cent in China from 2014 to 2025 – with China representing 16 per cent of global GDP in 2025.
 - At two per cent in the United States from 2014 to 2025, so the United States will represent 20 per cent of global GDP in 2025.

Retail consolidation and branding

- Retailers struggle to manage the volatility in prices, leading to forced consolidation in many markets as some retailers go out of business.
- The uncertainty around volatility creates a reluctance to invest in branding – there is limited investment driven by the big brands, which are growing faster than rest of market.

Consumer attitudes about diamonds

- Consumers increasingly move away from diamonds to other, and less conspicuous, categories of luxury goods and experiences, especially in China, but also in Europe and the United States, driven by:
 - Decreased investment in branding by global luxury groups
 - Wealth and luxury taxation becoming more likely
 - Conspicuous consumption becoming less prevalent during periods of recession.

Supply of rough diamonds

- The global economy experiences high levels of volatility, and the diamond industry is very cyclical, with strong increases in demand preceding sharp decreases, leading to scattered supply expansion as companies avoid making major investment decisions in the face of market volatility.
- Recycling increases, driven by consumers' financial distress.
- Lead time between the demand and supply cycles leads to a strong variation in prices.

Potential implications for players in the value chain

- Overall management of the diamond jewellery retail industry will likely improve as struggling companies with an opportunity for turnaround become attractive targets for mergers and acquisitions.
- Volatility in growth could lead to strong increases in demand followed by sharp decreases, which would result in high levels of price volatility. Financing could become much more difficult for everyone along the value chain – especially midstream players.
- Even under such difficult circumstances, demand would continue to outstrip supply. However, producers will likely find it more challenging to match production volumes to changes in demand, and inventory levels will, therefore, likely go up.



Three potential shocks to the system

Three potential shocks could, in the unlikely event they occur, profoundly disrupt the diamond industry: an extreme drop in demand, social or political upheaval in core markets and resource nationalisation in major producing countries. Although these are low-probability events, the large negative impact that they would inflict on the diamond industry if they did occur should inspire players across the value chain to ensure they are fully prepared in order to protect their businesses:

1. An extreme shock to demand

If consumers lost faith in diamonds, either because they lost faith in the natural diamond supply chain, for example, through an influx of synthetic diamonds, or if diamonds lost their emotional equity, a reputation-driven demand shock might occur. This could have effects similar to those in the fur industry in the 1990s, following extensive negative exposure in the media.

Similarly, a policy-driven demand shock might occur if policy makers in one of the big growth markets intervened to restrain or even ban the purchase of diamonds.

2. An economic derailment in India and China

Significant financial, economic and social upheaval in core markets, such as India and China, could lead to instability and, potentially, even movement away from the market economy. This could, in turn, lead to a drop in the demand for luxury goods.

3. Resource nationalisation in major producing countries

If one or several of the major diamond-producing countries were to nationalise their diamond mines, this could have a severe impact on the overall industry (similar to what happened to the oil industry in the wake of nationalisations in the 1970s). It would fundamentally disrupt the value chain, potentially with governments moving much more radically to establish their own players along the value chain.



Conclusion

An analysis of the range of potential scenarios outlined here suggests the diamond industry will likely continue to be a robust and profitable sector, with demand growth outstripping supply. At the same time, the industry is being fundamentally reshaped by ongoing developments and will likely need to evolve further over the coming years. Some of these developments depend on which scenario comes closest to reality, but others are likely to play out regardless.

Overall we see a range of opportunities – and imperatives – for industry players:

- Diamond jewellery retailers will likely see increasing competition and will need to invest in branding and innovation in order to differentiate themselves.
- Midstream players will need to evolve to meet increasingly complex demand from an evolving downstream sector.
- Faced with increasing mining costs, pressure from host countries to extract more value as well as the limited new sources of supply, mining companies will need to innovate their operations, manage capital in a more disciplined way and increase their focus on governmental relations in producing countries.

