FLASH

Hidden gems – digging for unique plays in the diamond industry

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Lucara Diamond Corp recently discovered the world's second-largest gemstone in history - the 1,109carat Lesedi La Rona and has just announced its sale to Graff Diamonds for $53m. The company is one of the foremost producers of Type IIa diamonds and its consistent recovery of large stones of more than 100 carats makes it a unique opportunity in the complex but intriguing diamond industry.



Claire Shaw
European Mid & Small Cap Equities Expert

> *« Our research edge lies in buying unknown and unloved stocks - Lucara is a perfect example of this. The business is not widely covered by the sell side and the market was punishing its shares for suffering a perfect storm of negative factors in 2017 - our long-term time horizon allows us to take advantage of this short-term pessimism. »*

The long term supply/demand dynamics are very favourable for diamonds - worldwide demand is set to grow 2-5% pa until 2030, driven by the growing middle class in countries such as China and India. Yet supply is expected to decline by 1-2% pa during this period - the lack of new mines in the diamond industry is well documented and many are due to reach the end of their useful lives. Further compounding the supply issue is that of the estimated 7,000 kimberlite discoveries that have been made in the last 140 years, only seven of them have become Tier 1 mines - uncovering quality mines has been a challenge.

Lucara Diamond Corp is a pure play diamond miner with its principal asset - the Karowe mine in Botswana - one of the world's key producers of large, exceptional stones. The company began production in 2012 and, since then, has recovered 73 gem-quality diamonds of over 100 carats and 145 diamonds that have sold for over $1m. This consistent recovery of large stones, combined with newly installed state-of-the-art mine optimisation machinery, provides a long-term competitive advantage against an attractive industry backdrop.

One of the key attractions of the investment case was the strength and quality of the company's management - evidenced through the fact that they have returned 25% of the market cap to shareholders in the last five years via dividends and special dividends. This alignment of interest between management and shareholders is a key factor in our process.

2017 has been a difficult year for the company - a change in operator at the mine temporarily hampered volumes, there was a lack of newsflow around new and large discoveries and it was operating in a sluggish diamond market. These short-term and essentially cyclical factors offered an attractive entry point - we bought an incredibly profitable company (EBITDA margins of around 55% and ROE's 28%) trading on very cheap multiples, with double-digit free cash flow yields and a 4% dividend yield.

In November 2015, Lucara made history when it recovered the 1,109carat Lesedi La Rona (meaning "our light" in Botswana's Tswana language), which is the largest gem-quality diamond recovered in the last 100 years and the second largest ever recovered. The recent sale of this exceptional stone, could also potentially trigger the announcement of a special dividend (which is what the company has historically done with the proceeds from large stones) - and sheds more positive light on a hidden gem in the European small- and mid-cap universe.

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