Firestone Diamonds

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Unpacking the diamond market with the 3Cs, and other short-hand tricks to understanding value

In February 2019, Firestone Diamonds PLC (LON:FDI) discovered a 70-carat diamond at its Liqhobong mine in Lesotho.

Liqhobong has yielded several large diamonds for Firestone in recent years, most recently a 46-carat stone unearthed in December and sold for just over US$1mln.

There's clearly big money in larger stones and Firestone's chief executive Paul Bosma was keen to underline the point.

"Although the market for smaller stones has been under pressure," he said after the 70-carat discovery, "we've seen continued demand and good prices realised for special stones."

Well and good - it seemed Firestone would realise at least US$1mln from its new stone, bearing in mind the price received for the smaller stone, and especially considering it was mined undamaged. But precisely how much it was likely to get remained an open question.

And just how exactly is the non-specialist investor supposed to know what the real implications of such a find are?

Here we unpack a few of the basics in putting valuations on diamonds and diamond mining companies, especially if they are trumpeting a particularly valuable find.

Diamond mines come in all shapes and sizes
Diamond mines come in different shapes and sizes. Diamonds are formed inside a rock known as kimberlite, named after the town of Kimberley in central South Africa. It was here that the South African diamond boom began with the discovery of an 85.5 carat stone known as the Star of South Africa in 1869.

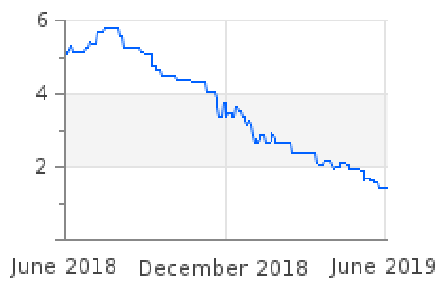
This sparked a rush of miners into the area, and the creation of what became known as the Big Hole, a giant hole dug vertically into the ground that's still visible today. The rock that the old timers were going through was unknown at that time, and so they dubbed it kimberlite, and it's a rock type that remains central to diamond exploration to this day.

Typically the richest kimberlites form in the shape of a pipe, as kimberlitic magma pushes its way up through fissures, in what's known as an intrusion. Kimberlite pipes are the world's richest source of diamonds and occur in only a few select areas of the world - most notably in South Africa and Botswana, in Russia and in Canada. Geologists are still searching for the ultimate source of diamonds found in Brazil and India, but as yet with no luck.

Price: 1.4p

Market Cap: £7.92M

1 Year Share Price Graph



Share Information

Code:		FDI
Listing:		AIM
52 week	**High**	**Low**
	6.20p	**1.32p**
Sector:		**General Mining - Diamonds & Gemstones**
Website:		**www.firestonediamonds.com**

Company Synopsis:

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Firestone Diamonds plc is an emerging force in diamond mining in Africa, with a diversified portfolio of production, development and exploration stage projects. Firestone operates the world class Liqhobong Mine in Lesotho and the BK11 Mine in Botswana. The planned expansion of production from Liqhobong is expected to move Firestone into the ranks of leading mid-tier diamond producers.

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For complicated geological reasons to do with the actual formation of the rock, not all kimberlites are diamondiferous. And the ones that are might not necessarily be economic to mine. But while those caveats apply to those companies in the early stages of exploration, it's also true to say that the world's richest diamonds mines, with one or two exceptions, are based around kimberlite pipes.

Of course, diamonds and geological time sometimes interact in surprising ways.

The surrounding kimberlite can get eroded, separating out the diamonds, particularly if there is an ancient watercourse in the area. In such cases, the diamonds are often transported in river streams and mixed in with other pebbles and silt. These are what are known as alluvial diamonds, and the effects of geological time can be so powerful that connecting them back up to the source may be ultimately impossible.

Alluvial diamonds are found in all the major diamond producing regions of the world, and in a few areas where kimberlites are unknown. The most famous example of this is the Marange deposit in Zimbabwe, one of the world's richest alluvial deposits, and the subject of much fighting and conflict in recent years.

A secondary source of diamonds is the dyke. Usually, these are formed when the upward thrust of the molten kimberlite is hindered in some way and the magma splinters out laterally in smaller streams. These dykes can be equally diamondiferous, but the erratic nature of their formation means they can be extremely difficult to mine effectively.

Analysts' models: art or a science?
It's somewhat paradoxical that the scientific modelling of mines and future mines by analysts always involves a significant number of assumptions. For a start, analysts always build in price assumptions that are based on educated forecasts, but which can never properly take into account sentiment or a wider shift in the global economic backdrop. As Firestone Diamonds chief Paul Bosma said on the discovery of that 70 carat stone, the prevailing market for small stones was weaker, while pricing for larger stones remained strong.

The world of pricing diamonds is nuanced and subtle and hard to predict. In the old days, before about the year 2000, there existed a massive stockpile held by De Beers, the world's number one diamond miner and the onetime owner of the Big Hole that got dug at Kimberly after 1869. That stockpile was used to manipulate and control prices, but it's gone now. Instead, the international diamond market now relies on an aggregation of prices achieved at tenders all round the world in order to get an idea of how much stones are worth in any given month.

The tendering system involves packaging up parcels of stones and then offering them out to buyers for tender. The buyers put their bids in in secret, and the highest bid wins. It's simple, except that this type of sale only encompasses mid-sized and smaller stones, which are sold together, in parcels, and thus it's hard to establish a precise value for any particular stone. Larger stones get priced individually at auction, and the market there is even harder to predict, because there isn't always a Richard Burton around looking to impress an Elizabeth Taylor.

The three Cs: carat, cut, clarity

So, it's only when you reach the retail level that the value of diamonds really becomes clear. Here, the traditional valuation tool of the three Cs holds as good as it ever did.

First, carat. The bigger it is, the more valuable, allowing that required parameters of the two other Cs are also met.

Second, cut. The art of the diamond cutter, honed in particular in Antwerp and Bombay, is key. The better the cut the greater the lustre, and the greater the value. But there's also another factor. The most skilled cutters will ensure that the maximum amount of stone is retained, and that the off-cuts are kept to a minimum. This takes us back to the first of the Cs, and ensures that the amount of carats in a stone is as high as possible.

Third, colour. This is subjective to some degree, since in the case of larger stones, the market often pays top dollar for exotic pinks or blues. Nevertheless, at the mid-to-smaller end of the range, the clearer a diamond is, the better value it will attain. The industry jargon for an opaque or imperfect stone is "occluded", and discounting can be heavy if the depth and extent of the impurity is marked. Having said that, most diamonds are imperfect, so impurity is not necessarily considered a deal-breaker.

A big diamond isn't necessarily a buy signal

Every diamond company likes to trumpet its larger finds, in part because it reassures investors that cash flow will be healthy, and in part too because it serves as a way of promoting companies and projects generally.

Petra Diamonds LTD (LON:PDL) has proved itself particularly adept at this over the past few years, marketing itself on the back of several large stones to an effective degree. However, investors should be wary of reading too much into the discovery of these stones. In most cases the potential discovery of large stones form part of a company's internal modelling, since the ratio of large stones to smaller ones, though small, can often be fairly consistent in a kimberlite pipe.

Tim Read, formerly a director of Kopane Diamonds, which was taken over by Firestone, used to put it like this. "Once you get on the bus route, you don't necessarily know when the buses are going to come, but you know that they will, and with relative frequency."

And that means that companies, professional investors and analysts alike have usually built in the discovery of large stones into their plans and models. When large stones do turn up, it's a payday for the PR companies, but its also part and parcel of the business of diamond mining.

Key considerations when assessing diamond companies

- Grade, measured in carats per hundred tonnes
- Types of deposit - kimberlite, dyke or alluvial?
- Types of stone on offer
- State of the wider diamond market


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