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HW.TO - Q4 2012 Harry Winston Diamond Corporation Earnings Conference Call

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Harry Winston Diamond Corporation fiscal year 2012 fourth quarter and year end conference call. My name is Chanel and I will be your conference coordinator for today. At this time, all participants are in a listen-only mode. We will conduct a question-and-answer session towards the end of today's conference.

As a reminder, this conference is being recorded for replay purposes. Please note that we will be making some forward-looking comments today. Various factors and assumptions were applied in deriving these comments and actual results could differ materially. The principal factors and assumptions that were applied and risks that could cause our actual results to differ materially from our current expectations are detailed in our filings with the Canadian and United States securities regulatory authorities and can be found at www.SEDAR.com and www.SEC.gov.

During today's call, we will also be discussing certain non-GAAP financial measures such as EBITDA. EBITDA does not have a standardized meaning according to GAAP and Harry Winston defines it as sales minus cost of sales and selling, general and administrative expenses. Please see the press release and the MD&A we filed yesterday for further information about this non-GAAP measure.

I would now like to turn our presentation over to your host for today's call, your Chairman and CEO, Mr. Robert Gannicott. Please proceed.

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

Thanks. Well, good morning, everyone, and welcome to this call, which of course as you just heard, incorporates both the fourth quarter and the year end results. Before I proceed, I am just going to introduce some of the other people that I have sitting with me in the room and that are available to help with answering questions at the end of the call.

As well as Frederic de Narp, who runs our luxury goods subsidiary, based in New York, and Cyrille Baudet, who is our Chief Financial Officer, who will be actually speaking on the call -- as well as them, I also have Ray Simpson here. Ray leads our M&A research group. Richard Chetwode, who now runs our Investor Relations program as well as our relationships with capital markets generally. Ray, most of you know from quite a long time. Richard has recently joined us. His background is he came to us from Gem Diamonds. Prior to that, a long career with DeBeers. And before that, he actually worked in the city of London for James Capel.

Also in the room I have Mats Heimersson. Mats is a Swedish mining engineer who has always worked in Arctic. He began his career in Arctic Sweden. Mats and I then met in the mid-1970s on a project -- a mining project in West Greenland, where Mats introduced a very innovative mining method for one of the ore bodies at the mine. He has since spent his time working on a lot of the Arctic mine startups, including Polaris and Lupin, and having some involvement with Nanisivik as well. Mats is based in Yellowknife and is our prime resource on mining engineering issues.

So, following that introduction, I am just going to say then I am now going to hand over to our CFO, Cyrille Baudet, who is going to review the year from a financial performance point of view. Cyrille will be followed by Frederic, who will discuss the brand timepiece and jewelry business, and I am then going to come back to discuss our rough diamond business.

By way of introduction, I'd say the year in diamonds generally and our business in particular has in large part reflected global economic developments. The early part of the year saw a strong surge in rough diamond prices as demand anticipated a strong and immediate US recovery supplementing the new demand from China. This drove our own rough prices up by about 50% between the beginning of the year and July, at which point European debt issues and uncertainty in the US recovery reversed that trend.

In the second half of the year, most that not all categories of rough diamonds surrendered about half the gains made in the first half. The most resilient categories being those delivering small, high-quality stones used in the watch industry, and the weakest categories being the lower-quality diamonds where competition from the Marange area of Zimbabwe has had an impact as those diamonds have come to market following a resolution of Kimberly process certification for them.

The average price for our own assortments of rough diamonds ended the year about 20% above the beginning of the year, and pricing and demand has now stabilized with most categories showing modest price increases again. Although we would all prefer more stable conditions than we saw over the last year, this experience has given a view of the effect of diamond supply/demand imbalance hitting the diamond market.

Our luxury brand business has shared the experience of other luxury brands and significant sales growth, as you are going to hear from Cyrille and Frederic. Perhaps more important than the sales growth itself is that we continue to build the foundations of a strong bridal jewelry and timepiece business to deliver more predictable growth than can be expected from reliance only on high-end sales.

Our Japanese business has been particularly effective in this transition despite the challenges of the tsunami tragedy earlier in the year.

I'm now going to turn the call over to Cyrille. He will be followed by Frederic, and then I am going to return later to discuss the mining operation and the diamond market.

Cyrille Baudet - *Harry Winston Diamond Corporation - CFO*

Thank you, Bob, and good morning, everyone. As Bob and Fredric will discuss our segment results and operational performance for the quarter, full year and outlook in detail, I would like to speak about the consolidated and additional financial result for the same periods.

Some new items to note this quarter. We have improved the way we are reporting regional sales segments to provide you with added disclosure. Mining and luxury brand segments now disclose sales by four geographical regions, being North America, Europe, Asia excluding Japan, and Japan. Our geographic regions now reflect where the item was sold. Previously, our sales were based on where delivery took place.

We also decided to break out Japan from Asia to better inform you of the source of our Pan-Asian sales. As most of you are aware, we are well-established in Japan versus Asia, where we have only fairly recently started to develop our business.

Additionally, the Company now reports a third segment, corporate, separate from the mining and luxury segments, to improve visibility on our core businesses. The corporate segment captures costs not specifically related to operations of the mining or luxury brand segments. The corporate segment mainly attracts SG&A.

Also just a point of clarification, we define high-value transactions as sales in excess of $5 million.

Now to the results. For the fourth quarter, our consolidated sales were $216 million, with $102 million from the mining segment and $114 million from the luxury brand segment. This was slightly up at 0.3% in reported currency or down 3% on a constant currency basis. Higher sales in the mining segment fully offset sales decline in the luxury brand segment.

Our consolidated gross margins in Q4 were 39.9% of sales, up 560 basis points from the comparable quarter of the prior year at 34.3%. This was driven by the higher gross margin for both the mining and luxury brand segments.

Mining gross margin as a percent of sales in the fourth quarter was 28.8% versus 25.2% in the comparable prior-year period. Gross margins for mining benefited from both higher average sales price per carat sold and higher volume of carat sold.

The luxury brand segment gross margin as a percentage of sales was 49.9% versus the 40.1% in the comparable prior-year period. The 9.8 points of improvement in the quarter was driven by the product mix with a higher proportion of sales in fiscal 2011 coming from high-value transactions which carry lower than average gross margin. During the most recent quarter, there were $6.7 million of high-value transactions compared with $48 million in the comparable period of the prior year.

Consolidated SG&A expenses increased 5% to $55.5 million in the first quarter versus $52.7 million in prior-year period. SG&A for the mining segment decreased $1 million in the quarter due to a reduction in professional fees. And on the luxury brand side, SG&A increased by approximately $2 million in the fourth quarter versus the prior year. The increase was primarily due to higher advertising, marketing and selling expenses and increased rent and building related expenses.

As a result of the sales decrease in the quarter, SG&A as a percentage of sales increased to 44% of sales versus 36% in the prior-year period.

Corporate SG&A increased $1.6 million for the quarter primarily due to travel expenses and salaries and benefits related to additional corporate employees.

Consolidated operating profit for the quarter was up 45% to $30.7 million versus $21.2 million the prior year and EBITDA was up 27% to $58.2 million versus $45.9 million the prior year. As we have already mentioned on the calls, we believe it is better to evaluate our results on a four-quarter basis as the timing of high-value transactions can skew an individual quarter.

Now to talk about the fiscal year. For fiscal 2012 our consolidated sales were $702 million, an increase of 13% or 9% on a constant currency basis. These are very good results when you consider the disruption during the fall in the rough diamond market and the fact that we held back inventory during the third quarter to wait for better market conditions.

Fiscal year our mining sales increased 4% and luxury brand sales increased 19%, or 12% at constant exchange rate.

Our fiscal 2012 consolidated gross margins were 35.6%. Recall in the third quarter of this year we took a non-cash paste plant derecognition charge of $13 million. Excluding this charge our consolidated gross margin would have been $37.5 million versus the comparable prior-year period of $37.9 million. Excluding the paste plant derecognition charge, mining gross profit margin decreased 50 basis points to 25.9% of sales versus the prior-year period of 26.4% of sales. This decrease was driven by the result of higher volume of production from the higher-cost underground mine.

Consolidated fiscal year SG&A increased by 15% to $193.6 million, compared to $168 million in the prior year. Mining SG&A increased by about $2 million due to stock-based compensation and executive severance costs.

For the luxury segment, SG&A spending increased by $20.8 million or 14% for the year. This was at a pace less than our sales growth for the year of 19%. We ran at a 41% of sales rate for the luxury brand in the current year versus 43% in the prior-year period. The increase in luxury brand spending was due primarily to higher advertising, marketing and selling expenses, higher variable compensation expenses resulting from higher sales and increased rent and building-related expenses. The SG&A spending is supporting our growth strategy, including store expansions and brand-building initiatives.

Corporate SG&A increased $2.9 million during the year primarily due to stock-based compensation, travel expense and salaries and benefits related to additional corporate employees. Fiscal 2012 consolidated operating profit was $56.5 million or $69.5 million, 10% of sales, when excluding the paste plant derecognition charge.

Operating profit excluding the paste plant derecognition charge is up in dollars but down one margin percentage point versus the prior year operating profit of $68.3 million or 11% of sales in fiscal 2011.

Operating profit decreased on the mining side essentially due to the paste plant derecognition charge and due to the increased SG&A described previously. On the luxury brand side, operating profit increased both as a percentage of sales and in absolute dollars.

Our profits are still largely being driven by the mining segment, as the luxury brand is in a major growth phase. The evolution of luxury brand profit and EBITDA is very positive, and we continue to be in the free cash flow generation phase on the mining side.

When excluding the paste plant derecognition charge, consolidated net profit decreased versus the prior year, primarily due to non-operating items, including higher income tax expense, higher financing expenses related to the Kinross buyback transaction, with the final payment made in August 2011, and the higher mining exploration expenses. The higher income tax expenses primarily resulted from the re-evaluation of both nonmonetary assets and liabilities and of the net deferred income tax liability due to foreign exchange fluctuations.

Consolidated EBITDA was $148.2 million this year compared to $145.4 million in the prior year, an increase of 2%. Mining EBITDA was $127.4 million versus $125.7 million. And luxury brand EBITDA was $31.8 million for this past year versus $27.2 million in the comparable prior, which is up by 17%.

Our liquidity is solid, with cash of $78 million and availability under our credit facilities of $124.5 million as of January 31. As mentioned previously, during the year, we repaid the Kinross promissory note of $70 million plus all accrued interest from cash on hand.

The Company is in the process of refinancing its senior credit facility for the luxury brand segment, and the senior secured mining facility has another two years expansion available beyond next year's maturity.

Now I would like to turn it over to Frederic.

Frederic de Narp - *Harry Winston Inc. - CEO, President*

Thank you, Cyrille. Overall, this past year has certainly been very good for global brands that sell luxury products. Luxury retailers have recorded strong year-over-year growth in sales. During the year, the industry was confronted by the challenges of the earthquake and tsunami in Japan as well as the impact of the sovereign debt crisis in Europe. More than offsetting these challenges, the creation of new, young, wealthy consumers in emerging markets continues. These new consumers have a desire for branded luxury products that reflect their status.

Tourism from emerging markets, especially from China, has fueled a significant increase in demand for luxury products around the world. These new wealthy consumers are driving demand for branded luxury products in Europe and in the United States as well as in their local markets. The long-term trend of wealth creation, which is translating into demand for luxury products, is firmly in place. We believe that Harry Winston is very well-positioned to benefit from this trend, which will support our objective of driving sales and profitability growth over the coming years.

I will speak more about the next year in a moment, but first I would like to discuss our sales results for the fourth quarter and the past fiscal year. As you know, each quarter, sales will have variability depending upon the timing of certain high-value transactions.

Now, the fourth quarter. The sales during the fourth quarter were $114 million, down 14% on a current exchange basis, and lower by 18% on a constant exchange basis. While sales declined in the fourth quarter versus the prior year, gross margin increased to $57 million versus $53 million in the prior year, primarily due to product mix shift.

During the fourth quarter of the prior year, several significant high-value transactions were generated from our Court of Jewels event that we are not repeating in the current period. These significant sales were generated in America and in Asia outside of Japan. The Court of Jewels event was a one-week event held in New York during November 2010 where the Company displayed a collection of jewelry and watches with a retail value well in excess of $1 billion, including the historic Hope diamond, to an audience of celebrities, journalists and important clients. Excluding these prior year high-value transactions, our bridal, timepieces and jewelry collections all performed well, generating significant growth over the prior year.

Regionally and at constant exchange rates, sales for the fourth quarter in Europe were up 79%. Japan was up 10%, North America was down by 11% and Asia outside of Japan was down 68%. During the fourth quarter, we introduced a new timepiece collection, the Ocean Sport, as well as High Jewelry Collection- Ultimate Adornments.

We continue to expand our distribution network with the opening of a new salon in Shanghai in the Peninsula Hotel, as well as a second licensed salon in Dubai during the quarter. Gross margin percent for the quarter was 49.9%, representing a significant improvement over the prior year gross margin of 40.1%.

As I mentioned, the improvement in margin was driven by product mix as well as a successful launching of new products supported by a strong advertising campaign. Operating profit in the quarter was up to $6.8 million or 6% of sales compared with $5.3 million and 4% of sales in the prior-year quarter.

Now, the fiscal year. The sales for the fiscal year were $412 million, up 19% at current exchange rates and 12% on a constant exchange rate basis. Similar to the quarter, change in the product mix contributed to a 16% increase in gross margin to $188 million versus $163 million in the prior year. All regions generated increased sales over the prior-year period on a constant exchange basis.

First, North America was up by 23%, benefiting from tourists from emerging markets. In addition, we generated significant increases in our bridal and timepieces business, supported by a strong advertising campaign. In the European region, sales increased by 8% as a result of increasing demand for luxury products from clients from Eastern Europe, the Middle East and Asia, offsetting the challenges of the sovereign debt crisis. Europe's results benefited from two new licensed salons in Dubai.

In Japan, sales rebounded strongly, increasing by 13% over the prior year in spite of the impact of the earthquake and tsunami. In Asia outside Japan, sales were up for the year by 5%. We are focused on expanding our distribution network in China with the opening of our salon in the Peninsula Hotel in Shanghai in January and our flagship Shanghai salon that just opened last weekend.

Gross margin percent for the year was [45.7%] (corrected by company after the call) compared with 47.2% in the prior year. But gross margin increased to $188 million from $163 million. The gross margin percent was impacted by several high-value transactions that generated lower than average margins, as well as the cost to launch our new watch collections. We had $67.5 million in high-value transactions this year versus $54 million in the prior-year period. Gross margin benefited from higher sales and improved product mix.

The operating profit for the year was $19.4 million and 4.7% of sales compared with $14.9 million and 4.3% for the prior year. This past year represents the second consecutive year of increasing sales and profitability for the Company.

Let's talk about the outlook now. We believe that the underlying economic fundamentals in place indicate that demand for luxury products will continue to increase over the long term. In the new fiscal year, we will continue to execute our long-term strategy by expanding our distribution network, introducing new jewelry and watch products, using only the finest materials and craftsmanship, increasing financial commitment to promoting the brand, hosting powerful branding events and continuing to strengthen our supply chain.

We are thrilled to have opened our largest salon in the world in Shanghai this past weekend, with our grand opening celebration gala scheduled for April 27. A new salon in Harrods in London is scheduled to open during the month of July, increasing our directly-operated salons to 22. In addition, we plan to open one licensed salon in Russia in May, and one in Kuwait in the fall, bringing the total of licensed salons to six.

Our wholesale distribution network is planned to expand by 25 to 30 doors to approximately a total of 220 doors by year end.

We have just returned from the Baselworld Fair. The Fair represents the most important watch event of the year. The overall mood at the Fair was very positive. Our new, innovative and high-design time piece products were very well-received. We received a great deal of favorable press regarding our new Opus 12, the unique Feather watch collection and our older watch products.

We are reconfirming our long-term vision through 2016 as follows. Growing sales at a compound annual growth in the mid teens. Improving our gross margin to the low 50s. And improving our operating profit margin to the low to mid teens. We plan to expand our distribution network to approximately 35 directly-operated salons and 15 licensed salons, and to grow to 300 wholesale timepiece doors by the end of fiscal 2016.

These are exciting times. We believe that we have positioned the Harry Winston brand for significant growth in sales and profitability over the coming years. I am very confident we will achieve our objectives. I would like to pass the call back to Bob.

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

Thanks, Frederic. Thank you, Cyrille, as well. As you have seen in our press release, our originally planned presentation of a life-of-mine plan has been delayed in recognition of Rio Tinto's announcement of a strategic review of its diamond business, which obviously raises the prospect of possible disposals.

We have of course presented a forecasted diamond production and operating budget for the coming year, and we would expect to supplement this information as the year and Rio's process proceeds. But in the meantime, I won't make any further comments about the mine at this time.

Except to say that A-21 -- to discuss A-21 a little, the development of the A-21 open pit has completed an advanced initial review already and will now proceed to a, therefore, shortened final feasibility review. Although the capital costs for this project are in common with virtually any other capital project in the mining business these days, are higher than had earlier been expected, the return is still very definitely positive. And we believe that these higher costs are definitely realistic in the current environment.

The importance of the A-21 pit is that it brings ore feed to keep the processing plant filled as the underground mine becomes deeper and the therefore extended haulage distances put pressure on getting tonnes out of the underground.

Looking ahead then, we have already seen the Oppenheimer family surrender their helmsmanship of the diamond business with the sale of the family's ownership of DeBeers to Anglo American and the government of Botswana. The industry certainly owes them a debt of gratitude for expanding the horizons of diamonds as love tokens from the restricted market of royal families to their use in most of the developed world's marriage ceremonies.

This market expansion, although, is now ably accomplished by the marketing campaigns of the luxury brands.

We now also see the world's two largest mining companies both seeking to divest their diamond businesses in the realization that they are not of the scale of their bulk commodity businesses. Diamonds as a product are too complex to be treated as a commodity. It is a business for specialists in diamond mining, and particularly processing and marketing -- or combinations of those elements. Harry Winston, of course, is one of those specialists. We therefore look forward to an interesting and productive year ahead in both segments of our business.

So thanks for listening to us and we are now ready to take your questions. I am going to apologize in advance for the fact that we have to close to call at 9.25 because we all have to attend a Board meeting. But we have got 25 minutes to deal with questions.

QUESTIONS AND ANSWERS

Operator

Thank you. (Operator Instructions) Des Kilalea, RBC.

Des Kilalea - *RBC Capital Markets - Analyst*

Hi, Bob. Bob, a couple of questions if I may. The first is, just we -- from the release, maybe you could talk to the CapEx on A-21. And then maybe take us through, if you can -- I'm making an assumption that the decision as you kind of suggested not to release the Mine Plan is solely because Rio Tinto would have asked you to. Maybe take us through where Harry Winston has rights should Rio decide to dispose of -- do you have a right of first refusal? Maybe just put it in place where you stand on that.

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

Okay, thanks, Des. So two questions. I'm going to start off on A-21 then and Ray is going to give you a breakdown of that.

Ray Simpson - *Harry Winston Diamond Corporation - EVP*

Sure, Des. As Bob outlined, the process is not as if you were doing normal mine development, with a very clear cut prefeasibility/feasibility. But one of the reasons why the capital has gone up, it is not just inflation. We were looking at the different choices we had with the dike that we would put round the pits and mine it.

And with now looking at a -- I suppose you would say a lower risk option, but that is increasingly capital. So we still have to finalize that capital and both companies still have to approve that final project, but we hope that that project will start at the back end of this year, because we need to have the long lead items for equipment to come up the winter road.

Mats, I don't know whether you want to add anything to that?

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

No? Okay. Thanks. On the second question, as I recall, first one was whether Rio specifically asked us if we would defer the presentation of the mine plan. And the answer is yes, they did, understandably.

The second question is rights that we have under the joint venture agreement. The joint venture agreement, of course, is a confidential document. But we have in the past said that we do indeed have a first right of refusal, not of course on Rio's entire diamond business, but a first right of refusal on their 60% interest in Diavik. Does that get us there, Des?

Des Kilalea - *RBC Capital Markets - Analyst*

Yes, I suppose because of the confidentiality you wouldn't be able to go any further into whether the change of control -- if indeed there was a change of control at a beneficial level or a natural asset level, are you able to go into any of those kind of details? Is that treading into confidential water?

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

I think that is just getting a bit too lawyerly for this conversation. Obviously the intent of a first right of refusal is clear. And I would stress that we have always -- we have never had any issues in both Rio Tinto and ourselves treating one another properly with regard to the intent of the joint venture.

Des Kilalea - *RBC Capital Markets - Analyst*

Thanks very much, Bob. Thanks, Ray.

Operator

Irene Nattel, RBC Capital Markets.

Irene Nattel - *RBC Capital Markets - Analyst*

Thanks and good morning, gentlemen. Just following up on the similar line of questioning. In the past, Bob, you have said that you were interested in acquiring preproduction assets. Has your view changed given the recent announcements out of BHP and Rio?

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

No, it hasn't changed. But obviously we are interested in any assets like that that are relevant to our sphere of expertise, which has certainly got a northern Canadian focus to it. But brownfield projects, greenfield projects, as well as they are well-defined, we are certainly interested.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great. Thank you very much. And if we could just switch gears for a moment to focus on the Q4 results and the trends in Q1, both in terms of rough diamond demand and also luxury goods demand. As we are seeing some better overall tone in the economy, certainly we see it in the equity market, can you comment on the nature of demand that you are seeing, where you are seeing the biggest growth? You noted in the press release that we are seeing some strengthening coming out of the US. If you could speak to that, please.

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

Let me just speak -- I've got Frederic who will speak to that, with respect to the brand business of course. But if you like, we see the same thing of course on the rough diamond side. One thing I would stress is the demand for watches, with many of the watches for ladies being dressed with small diamonds, has had a dramatic effect on the pricing of those small diamonds -- the raw material for those stones. And so that in fact they are the prime example of an item that went shooting up the price in the first half of the year and has not given up any of those gains at all; in fact, has added more to it.

At the other end of the scale, though, of course, the cheaper goods that face both competition from Marange and perhaps some wobblers in consumer markets like India have been more challenging in their price. But fortunately these items don't mean a lot to our own production. But, Frederic, do you want to comment from the retail side?

Frederic de Narp - *Harry Winston Inc. - CEO, President*

Yes, I mean, exactly what -- as you were saying. On the watch segment, we have seen during the Basel show a large move and shift -- after SIHH and the Basel Fair, which are the two watch shows yearly -- we have seen many watch brands that are permanently men's watch brands changing and targeting the feminine segment much more than ever this year. So that is also fueling the demand for diamonds for the watch segment.

For the bridal segment, it has been steady; with or without any crisis, bridal is still growing on and on. We see it in our bridal segment. We see it in the marketplace, not only in China, that is the market discovering the diamond as a symbol of love, the engagement ring. We see about only 30% of the Chinese women with an engagement ring, while in America and in Japan you have more than 80% of the women with a solitaire engagement ring. But at this very moment, we see a large demand.

For the brand, Harry Winston, it has reinforced the bridal segment, which is increasing and the rate of increase is even stronger for engagement rings under $80,000, for the most accessible segment for us, which is extremely exciting.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great. Thank you.

Operator

Oliver Chen, Citibank.

Oliver Chen - *Citibank - Analyst*

Hi, guys. Congrats on solid results.

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

And to you on getting them right too, Oliver. Thank you.

Oliver Chen - *Citibank - Analyst*

Thank you. Congrats -- regarding the mining segment and thinking about the inventory that you may have held over in terms of selling in '12, what is the context of that happening? Also, are there any more Zimbabwe kind of overhang on the average price per carat which may impact the average price per carat of 12? Do you feel like the 120 that just occurred is a base from which the price may increase?

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

Okay. Well, first of all, our price per carat of course is made up -- is affected greatly by the mix of material that actually goes through the processing plant. We are mining from three different ore bodies. And in fact they were also reprocessing some material from the early days of the mine, which, if you'd like, almost constitutes a fourth ore body in (inaudible). So there are these different sources that go through the mill.

And the proportions that go through the processing plant determine the proportions of small versus larger diamonds that come out of the end, and that very largely affects the price.

In terms of stockpiling, if you like, we have pulled that down substantially since the beginning of the year. Actually only have a couple of tens of millions now of stock beyond what we have in normal working stock, work in progress, as it were.

We are not doing this because we couldn't sell the diamonds. We are doing it because of having the advantage of the luxury brand business and through its demand for polished diamonds, we are able to have a view, a very quick and early view, of what items are in demand and, therefore, which items are going to rise in price in the rough diamond end. And it sometimes makes more sense to hold onto the diamonds while the price rises rather than realizing the value and then receiving very little interest for the cash that is then put into the bank. So that is how we manage our stockpiling process.

Zimbabwe production, the Marange production, the issue during the last year was that the goods piled up in Zimbabwe because they were not granted export permits and certification under the Kimberley Process. Since about the third quarter of last year, the export licenses were granted, certification was given, so that we now have a steady flow of these goods coming out of the Marange fields of Zimbabwe.

And although they are taking their place in the diamond market, they are not really displacing very much other material, other than perhaps the very, very cheap end where prices have gone down quite a bit. These are not material that are making gems; they are materials that are used in industrial bort and things like that. But it doesn't really affect us very much going forward.

But our realized diamond price is very much a factor of what the ore release is from the individual ore zones within the mine and how much of the re-processed material is added into the processing plant as well. So you can just refer to our year forecast and the diamond prices that are attached to that and actually make your own estimate for the year.

Oliver Chen - *Citibank - Analyst*

Thank you. And my second question is related to the M&A market at large in the marketplace. Could you comment broadly on what you are seeing in valuation multiples? And also, given the limited and special nature of diamond supply, what do you think about the marketplace and potential bidders? It feels like there is a wide spectrum of potentially interested parties from strategics to financials.

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

I am not going to comment too much on this, for obvious reasons. But, I guess what I would say is it looks to me like a narrowed field. Obviously when -- at the time when there were three large -- three of the world's largest mining companies that were all players in diamonds, that this was a broader field than it is now, where there is only one of the super majors, if you like -- Anglo American is the only one that is actually a part of the diamond business now.

I think it is -- my own view is it is a very specialized business. The mining part of it is pretty much the same as it is for anything else. But beyond that, to be able to process the ore properly, to be able -- particularly to be able to sort and sell to realize the full market price for rough diamonds is a very specialist trade. It is not something that is easily undertaken by someone that is just a financial investor that wants to be invested in the diamond business. I think it will always require at least the strategic partnership of someone that has the broader knowledge base.

Oliver Chen - *Citibank - Analyst*

Thank you. And finally on the luxury side, we were very impressed with the product portfolio at Basel. A couple of questions. In terms of watches, as a percentage of mix, what -- how many basis points do you think that watches will increase as a percentage of mix in '12 approximately?

And then lastly on luxury, in terms of our financial modeling, on a go-forward basis, are there any quarters in which we should think about potential high-value sales occurring? And also you gave some great information about high-value sales from last year. Are we anniversarying any high-value sales that we should know about in particular quarters in the year that we just closed?

Frederic de Narp - *Harry Winston Inc. - CEO, President*

Right. So first question on the watch mix. You know, watches are still representing a very small part of the business of our own salons, so we are going to tackle that. It is too minor and we should be able to sell many more watches. So we are starting a new experience by opening the largest salon in the world. I was talking about in Shanghai, Xiantiandi, last weekend. This is the real first salon where you have an entire watch salon inside our own salon, with watch advisers, watch assortments, watch strategy around it. So we want to sell more watches through our own salons. That is the first part to create more traction on the watch segment.

The watch segment today is less than a third of our business, way under a third of our business. And there is no limit to what watches could represent for our brand that has such a perception in the watch segment. And I see it when we sell watches at $250,000 like Opus and they are all sold out in four days time at Basel, for example.

So watches are still our super-strong priority for the next 24 months.

High-value transactions, nothing I can share with you at this very moment. What I can tell you is that we want to do a regularly huge event. We did the Court of Jewels, huge event, November 2010. Now our huge event of the year takes place the 27th of April, and again, we want to leverage this event worldwide. We will have press from all over the world, VIP clients from all over the world, and do expect big sales from this moment, yes. So potentially second quarter, but not that I can share more.

Oliver Chen - *Citibank - Analyst*

Great. Thank you. Thanks, everyone, for your time.

Operator

Seth Peterson, Berenberg Bank.

Seth Peterson - *Berenberg Bank - Analyst*

Good morning, everyone. Two questions, one regarding the mine and one regarding luxury. When we talk about the mix of ore coming from the different pipes, if I understood in the release today, there will be approximately 1 million carats coming from the A-154 and 1 million coming from the A-418. And I believe you have said that approximately half of the carats coming from A-154 will be from South and about 50% will be coming from North. Do you have a similar weighting for A-418 that you could give us, and did I interpret that correctly?

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

Well, I will ask Ray to comment on the actual numbers. But just to point out, A-418, there is only one A-418. Part of it is being mined from an open pit and part from underground. But it is only one ore body, one ore type now. Whereas A-154 South does have a North pipe and a South pipe -- A-154, sorry -- has a North pipe and a South pipe. And they behave differently in a mining sense and the diamonds in them are different too.

A-154 North contains the best diamonds that we have in the entire suite, but it's somewhat lower grade. So you have got some lower carats per tonne, but a higher value per carat. A-154 South is the one that has got the highest grade. A-418 has a good grade, but the diamond production is finer so the average price is lower. Ray, do you want to comment on the mix?

Ray Simpson - *Harry Winston Diamond Corporation - EVP*

Just to add to Bob's comment there, the A-418 ore body we use to define two different types, the A type and the B type. The B type has lower-value diamonds. Really, it was a size distribution, a smaller average size for those goods.

When mining this pipe, they found it quite difficult during the mining process to differentiate between the two types of ore. So in our outlook we didn't want to split up as two types as ore, because the mining engineers and the operators weren't sure exactly on that mix.

So going forward, we have tended to look at this ore body as a whole, as Bob described it, as one ore body that has these two parts. And we may well change in the future; when we give an indication of diamond price for each of the pipes, we may well roll those two parts together. But, other than that, I think your numbers were pretty much right, and understanding the difference between the grades and the tonnage between each of the pipes.

So the only thing we have to accept with the change for looking at 418 as one ore body is there's a little less accuracy on us forecasting value, but of course we don't intend to put that in our releases anyway. So, Mats, I don't know if you got anything to add?

Mats Heimersson - *Harry Winston Diamond Corporation - Consulting Engineer*

Not really. I think it covers it.

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

Okay?

Seth Peterson - *Berenberg Bank - Analyst*

Good, okay. And then the question regarding luxury. Should we assume that there will be a continued increase in marketing expenditures this year? Should we assume that in percentage terms, the amount will be similar to what it was last year or will it be higher?

Frederic de Narp - *Harry Winston Inc. - CEO, President*

Well, now entering this new year, you should expect the gross margin to increase and the mix of products shifting having great results to the bottom line, quarter after quarter. And therefore, while we're increasing our gross margin, we will be increasing a little bit our marketing spend quarter after quarter. Cyrille, do you want to bring some more color?

Cyrille Baudet - *Harry Winston Diamond Corporation - CFO*

Yes, I mean, if you want to look at our SG&A, because of this huge cost base that we have in Switzerland, you really want to look at that on a (inaudible) basis. And the number that you have from FY '11 to FY '12 is that at (inaudible) basis our sales have increased 12%, our gross margin has increased 8% and our SG&A has also increased 8%. So we have preserved our ability to deliver operating results, but we have not increased it. And of course the intention is to grow the SG&A at a lower pace than gross margin. But in order to do that, we need to carry on changing the product mix in our sales and we need to gain some more volumes in order to have some scalability, if you will.

Seth Peterson - *Berenberg Bank - Analyst*

So in theory, in any given quarter, we may see some fluctuations. But for the year, we should assume that in percentage terms, there will be no major increase?

Cyrille Baudet - *Harry Winston Diamond Corporation - CFO*

There should be an increase that goes at slower pace than the increase in margin. Of course, as we are opening stores, we are going to expend some new rent, expand some new depreciation. But the objective is clearly to start growing the margin at a much faster pace than the growth of SG&A.

Seth Peterson - *Berenberg Bank - Analyst*

So just to be clear then, is that the objective for the current fiscal year? Or is that more likely to be something that will happen in coming years?

Cyrille Baudet - *Harry Winston Diamond Corporation - CFO*

It is an objective that should materialize in the current fiscal year.

Seth Peterson - *Berenberg Bank - Analyst*

Okay. Thank you.

Operator

Brian MacArthur, UBS.

Brian MacArthur - *UBS - Analyst*

Good morning. I just want to explore the plant rejects. Basically you are talking about getting it looks like a million carats from that this year, and from -- an extra 200,000 tonnes of processing, which indicates there is a fair bit of this. Can you just tell me whether that is likely to continue for a while. Like how much of this stuff is lying around? Because, yes, it is lower value carat but it is meaningful volume.

And B, the second question is whether it is on your balance sheet anywhere in broken ore anything like that or is this just kind of like a free option to the mine plan going forward?

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

Yes. Well, good morning, Brian. Yes, first of all, let's talk about where it came from. In the early years of the mine, when it was very easy to get large tonnages of high-grade material out the top of the A-154 South open pit, basically the processing plant was running at high capacity and intentionally not reprocessing porous rejects. In other words, the material that floated in the dense media separation and the cut above six millimeters was actually being put out into a separate pile in the -- it's not really the tailings area, but alongside it. So we always knew they were there. We knew why they were there. It's not because there was something wrong with the plant; it was a conscious decision in order to get a higher velocity of primary processing through the plant, and not using the plant capacity to deal with re-crush material, particularly at a time when small diamonds were not of the same price as they are today.

What I talked about earlier on the call, the demand driven by the watch business for small white stones has increased the price quite a lot, so these are an attractive product. They are not an ore reserve. They don't constitute any kind of measured resource. They are, as you said, like a bonus, as it were. How much there is of it -- Ray, do you have a feel for that?

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Ray Simpson - *Harry Winston Diamond Corporation - EVP*

So this year is the peak production probably for the RPR diamonds. So we will hope to get more diamonds again next year but at a lower level, and we will have a little bit less in 2014 to clear up.

I would also add, though, that particularly with the small diamonds doing well in pricing, we are going to be developing and adding circuits to the recovery plant that will help recover small diamonds. So what you will see is an increased recovery rate for small diamonds on an ongoing basis. So this isn't specifically from the RPR; it is just from normal production. But it is beyond what we are recovering at the moment. And that should flow forward through the rest of the life of the mine.

So again, just to summarize, back to RPR, it is at its peak level this year. It will come down something like 20%, 25% next year on the volume basis. And then there is a little bit less on the third year after that, in 2014.

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

Thanks.

Brian MacArthur - *UBS - Analyst*

And sorry, just to follow up. When you give the diamond price guides from the pipes right now then, would any of those small diamonds be weighted into that average price?

Ray Simpson - *Harry Winston Diamond Corporation - EVP*

No, they are not currently. There are those are based upon (inaudible) sort of like, if you like, a reserve statement average price.

Brian MacArthur - *UBS - Analyst*

Great. Thank you very much. That's very helpful.

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

Thanks, Brian. We will take one more question. And I can see that we have got three, I think, questions queued on the screen here, and just to apologize to anybody that we don't get to, and we will put top of the list once we get out of our Board meeting.

Operator

Des Kilalea, RBC.

Des Kilalea - *RBC Capital Markets - Analyst*

Thanks again, Bob and Ray. Could you please just briefly sort of speak to the liquidity in the cutting centers and whether you see any kind of restrictions, particularly in India, to normal trade the rest of this year?

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

Well, I have got some perspective on that. We have an office in India, as you know. Certainly I think liquidity has eased from the very tight conditions that were imposed much earlier in the year. But because the debt facilities are provided -- that are provided to that part of the diamond industry tend to be from European banks, there is obviously still some nervousness about banking in Europe in general. But as that nervousness eases, with the euro crisis getting at least put in abeyance for a while, there has been more credit available to the industry.

So I don't really see it as a constraint; I actually see it as something that has helped the industry to get itself out of bad habits. As you're very well aware, Des, the polishing industry used to be providing goods into particularly North America on like 180 day credit terms. And even if they weren't met, they just rolled over the credit facility. Well, that -- it has now become much more of a cash business and short-term credit, which is healthier all around, in my view.

Des Kilalea - *RBC Capital Markets - Analyst*

Thanks very much.

Robert Gannicott - *Harry Winston Diamond Corporation - Chairman, CEO*

Thank you. I'm afraid then we will have to close the questioning now. I want to thank you all for joining us. We are happy to take follow-up questions. If you direct the follow-up questions through either Richard Chetwode or through Laura Kiernan in New York or Kelley Stamm here in Toronto, they will make sure that they quickly get answered.

I would also like to draw your attention to the fact that we are running an Analyst and Investor Day in New York on May 10, where we are not just going to discuss the Company, but we're going to discuss the diamond industry broadly and set what we do in the Company into that context. It will be an opportunity to meet the broader management team in North America, as well as we plan to showcase some of our products there, of course. If you would like to attend that, then please contact Kelley, Kelley Stamm, who is sort of keeping the book on registration for it. So thanks very much for joining us.

Operator

Ladies and gentlemen, that concludes the presentation. Thank you for your participation. You may now disconnect. Have a great day.
