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HW.TO - Q3 2013 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 2013 third quarter conference call. My name is Marie and I'll be your conference coordinator for today. At this time, all participants are in a listen-only mode and 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.

Now 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 results to differ materially from our current expectations are detailed in our filings with 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-IFRS financial measures such as EBITDA. EBITDA does not have a standardized meaning according to IFRS 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-IFRS measure.

I would now like to turn the representative -- representation over to your host for today's call, your Chairman and CEO, Bob Gannicott. Please proceed, sir.

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

Thanks very much. Good morning, ladies and gentlemen and welcome to the third quarter update call. I'm in Yellowknife at the moment while the other two participants, Frederic de Narp, President of the Luxury Brand business, and Cyrille Baudet, our Chief Financial Officer, are both in New York.

This has been a quarter of solid progress for us on many fronts. Our luxury brand jewelry, particularly in the bridal sales category and timepiece business, have demonstrated strong growth with the higher margins and broader based sales that this implies. Our timepiece business is undergoing change as we bring wholesale management in-house rather than through agents but the new designs, more accessible watches have been well-received across a broader base supplement to the high end design in engineering that Harry Winston has become famous for in the world of virility.

As well as being very busy on the mining M&A front, we've also seen the Diavik Project switch fully to underground ore production with the closure in September of the A-418 open pit. Although the underground mine is still tuning its operating procedures, it has already reached and exceeded its planned underground production rate over the last few weeks.

I'm now going to turn the call over to Cyrille who will take us through the financial results. He'll then be followed by Frederic who will discuss the luxury brand business and I'm then going to return to discuss the mine, the rough diamond business and, to the very limited extent that I can, our potential acquisition of the Ekati mine. Over to you, Cyrille.

Cyrille Baudet - *Harry Winston Diamond Corporation - CFO*

Thank you, Bob. Good morning everyone. Our consolidated sales for the third quarter were $180.4 million, with $84.8 million from the mining segment and $95.6 million from the luxury brand segment. Our consolidated gross margin in Q3 was $65.7 million, which in value is 49% ahead of the third quarter of last year. And the Q3 consolidated gross margin as a percentage of sales was 36%, which is 50 basis points lower than Q3 last year.

In Q3, the mining segment generated sales of $84.8 million, a gross margin of 15.5%, compared to sales of $32.6 million and a gross margin of 5.9% in the third quarter of the prior year. Included in the cost of sales for the prior year was a non-cash $13 million charge related to the derecognition of the base plant. Excluding the impact of the base plant, gross margin declined versus the prior year, primarily due to the mix of carats sold with last year being primarily high value carats versus low value this year.

During Q3, the mining segment sold 0.88 million carats at an average price per carat of $96, compared to 0.23 million carats at an average price per carat of $156 in the third quarter of the prior year. The 39% decrease in the Company's achieved average raw diamond prices during this quarter resulted from the sale of our higher proportion of smaller size diamonds, due to an improved market for these goods.

The mining segment was at 0.8 million carats of rough diamond inventory, with an estimated current market value of $110 million, as at October 31. Out of these $110 million, $60 million represents rough diamond inventory available for sale, while the rest is inventory that is in the process of being graded and sorted.

On the luxury brand side, gross margin percentage for this quarter increased by 460 basis points compared to last quarter and by 25% in value. The improved results were driven by a number of factors. These include planned action as part of our long-term strategy like reduced sales discount, improved product mix with higher sales of bridal jewelry, timepieces and access jewelry, improved wholesale timepieces margin as a result of new product launches and higher production volume that creates operating leverage.

Consolidated SG&A expense increased 20% to $55.4 million in the third quarter, versus $46.2 million in Q3 of the prior year. SG&A for the mining segment increased $0.7 million in the third quarter, primarily due to costs associate associated with the Ekati transaction. On the luxury brand segment, SG&A increased by $6.6 million in the third quarter of fiscal 2013, or 16% versus the third quarter of last year. The increase was primarily due to higher advertising, selling and rent expenses related to the opening of our new salons.

We are making strategic investments in the brand and we expect SG&A to continue to grow through fiscal 2014 and then plateau as we begin to leverage SG&A spending. So far, we have made strategic investments in new product developments, systems, training and infrastructure, like new distribution offices in Hong Kong and Miami and new salons in China.

Corporate segment SG&A increased $2 million to $4.3 million for the quarter, primarily due to travel expenses and salaries and benefits related to additional corporate employees. The resulting consolidated operating profit for the quarters was $10.3 million, versus an operating loss of $2 million in the third quarter of the prior year. Excluding the derecognition of the $13 million base plant, the operating profit would have been $11 million last year.

EBITDA increased by 65% in the quarter to $34.8 million, versus $21.1 million in the third quarter of the prior year. The mining segment generated operating profit of $9.2 million on EBITDA of $29.8 million, compared to operating loss of $1.1 million and EBITDA of $18.8 million in the comparable quarter of the prior year. Excluding the derecognition of the $13 million in base plants, the operating profit for the mining segment would have been $11.9 million.

The mining gross margin was impacted by the sale of a higher proportion of smaller sized goods which carried lower than average gross margin in this current quarter. The larger size goods which carry higher than average gross margin remain as part of the inventory available for sale as at October 31. And closing inventory at October 31 has an estimated value of $110 million, with a cost of [$68 million] (corrected by company after the call).

Operating profits in the luxury brand increased 265% to $5.4 million, and EBITDA increased 101% to $9.1 million in the third quarter, compared to operating profit of $1.5 million and EBITDA of $4.5 million Last year. Our liquidity is solid with cash on hand of $110.8 million. We have refinanced the luxury brand senior facility to $300 million for five years and we have $75 million available on mining segment credit facility.

Now I'd like to hand the call over to Frederic.

Frederic de Narp - *Harry Winston Diamond Corporation - President Luxury Brand business*

Thank you, Cyrille. While especially as a New York brand, I would like to start out by extending our sympathies to all the families that were impacted by Hurricane Sandy. Our team and our clients suffered the impact of the hurricane and I want to thank our team for both determination in overcoming the impacts, as well as their generosity in helping others.

I would also like to mention that after a year of restructuring, we're thrilled to have on board a new head of our Geneva manufacturer who will help us reach our timepieces goals of producing 15,000 units in the medium term and also creating our own movements within the next four years. Now to the results.

The global luxury market has been quite resilient, generating healthy growth in sales during this past quarter. Luxury retailers are investing significant resources in expanding their distribution network in emerging markets, translating into growing numbers of new luxury consumers. Consumer demand for luxury products from strong Western brands continues to expand worldwide with a support of tourism from emerging markets. The China market directly, as well as through the benefits of tourism, is still providing the strongest growth in demand for luxury products.

Our positive results this quarter and the year-to-date confirm that the strategy that has been in place for nearly three years is working. This quarter we continued to strengthen our product assortment with introduction of new jewelry timepiece collections in access and core, and also [TMX] segments. Additionally, we are supporting the expansion of new products in our distribution network with strong innovative advertising campaigns, exciting promotional and selling events.

As a result, sales during the third quarter were up 14% on a current exchange basis to $95.6 million, and up 17% on a current exchange base as compared to the comparable quarter of the prior year. Most importantly, our gross margin improved to 55% during the quarter, from 50.4% in the comparable quarter of the prior year. The increase in margin was achieved as a result of increasing sales of excess products. Our operating profit increased to $5.4 million, or 5.6% of sales for the quarter, compared to $1.4 million, or 1.7% of sales, in the comparable quarter of the prior year.

We continue to experience strong demand for our new jewelry and timepieces products. Sales of products in the access and core segments continue to increase at double-digit rates in every single continent, translating into an expanding customer base while strengthening our margins. Regionally and at constant exchange rates, sales for the third quarter in Europe were up 47%, Asia outside of Japan was up 21%, America was up 7%, and Japan was up 1%, each as compared to the comparable quarter of the prior year.

Europe experienced strong growth due to the opening of a new salon in the Harrods store in London, in England, as well as several high profile events. During September, Harry Winston participated in the Biennale des Antiquaires at the Grand Palais in Paris, which is the most important fine jewelry exhibition in the world. At the exhibition, the Company unveiled its latest high jewelry collection, called Water by Harry Winston, and the jewelry exhibition provided the Company with the opportunity to showcase talents of its design team and craftsmen.

Harry Winston, Friday, announced that it is the lead sponsor of Hollywood costume and major new exhibition that is appearing at the Victoria and Albert Museum in London between October 2012 and January 2013, and the exhibition celebrates costume design in motion pictures and showcases the long relationship between Harry Winston jewels and Hollywood. Harry Winston, as you know, is known for loaning important jewels to generations of famous actresses, earning the title of jeweler to the stars.

The performance in Europe was very good, benefiting from higher sales of access and core products, as well as now direct to wholesale relationship we have in Switzerland. Partially offsetting these were some expenses related to the planned opening of our Switzerland flagship salon which will open next year.

In America, sales were up by 7.1% and performance was solid. We saw increases in sales in our New York City flagship salon, as well as in other North American salons benefiting from tourism such as Hawaii or Las Vegas. We continue to invest in our infrastructure, our supply chain improvement and direct to wholesale distribution in Latin and South America.

Driving higher sales in Asia outside of Japan were our new salons in Shanghai, representing a significant expansion of our presence in the all-important China market. In Japan, our growth in sales were strong in our salons driven by core and access bridal and timepieces. However, this growth was offset by the transition in timepiece wholesale distribution to an internal wholesale infrastructure.

Our long-term strategy requires that we balance our risk and growth as appropriate. In markets where we believe we can operate better than a partner, the strategy is to sell directly to watch retailers and gain significantly higher gross margin. In line with this strategy, the Company is in the process of taking over its wholesale timepiece distribution in most of Asia from a third party agent. And by the end of the current fiscal year, Harry Winston will have built an internal wholesale infrastructure to distribute its timepieces in Asia, in Europe, and in Latin America. Additionally, markets where we have a strong historical partners, we will continue to support these partners, both in wholesale jewelry and timepiece distribution and expand our network of licensed salons.

Our sales during the nine months ended October 2012 were up 5% to $314.5 million, as compared to the comparable period of the prior year. The Company generated high value transactions in the nine months ended October 12, amounting to $19.1 million compared with $60.8 million in the prior year. Excluding the high value transactions from both years, sales during the nine month period ending October 2012 increased by 24%, as compared to the comparable period of the prior year. Operating profit for the nine months ended October 2012 was $20.5 million, or 6.5% of sales, on sales of $314.5 million, compared to operating profit of $12.4 million, or 4.2% of sales, on sales of $298.1 million in the comparable period of the prior year, on a current exchange basis.

So these results reinforce the success of our strategy, both on sales and profit. Profits have benefited not only from improved mix, but also other fish initiatives such as taking back timepiece distribution or controlling the retail discount. Now on to the outlook.

Initial term, we're expecting reasonable growth except in high value transactions which are not as predictable. Our new salons in China have significantly improved our global distribution network in the fastest growing luxury market in the world. And new directly operated salon in Geneva, Switzerland is expected to be opened early next year and in addition, a new licensed salon is expected to be open in Kuwait City, Kuwait, during the first quarter of the next fiscal year. And the Company plans to expand by 15 wholesale watch stores to 216 doors by the end of this fiscal year, fiscal year 2013.

So we continue to focus on executing our long-term plan of growing sales and profitability by expanding our distribution network in prime locations around the world, introducing new jewelry and timepiece collections of the highest quality, supported by a strong advertising program leveraging the heritage of the Harry Winston brand. We are confident that Harry Winston is well positioned to continue to grow market share in the luxury jewelry and timepiece sector.

We remain true to our heritage by continuing to produce products that use only the highest quality materials and craftsmanship that our brand is known for. We are making every effort to balance our business, both retail and wholesale, access, core, ultimate product segment and make appropriate geographic expansion. This will help ensure we are not over exposed to any one time of client or geography or product, while growing the value of our brand.

I would like to pass the call back to Bob.

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

Thanks, Frederic. The Diavik Mine has made the transition to underground mining more successfully than had been originally anticipated. Expensive cut from fill mining has been replaced by a much lower cost combination of sublevel retrieve and blast hole stoping. Production levels have also ramped up faster than initially planned, despite the challenge of mining through the upper level of ground impacted by the open pit activity above.

In the upper level of the A-418 underground, this involved mining through and processing ore that contained large amounts of steel support material. This was a special challenge for the processing plant and led to mine production exceeding processing capacity for awhile. As a result of this, there are now 350,000 tons of broken ore stockpiled on the processing plant feed pad and about half of this will provide incremental feed during calendar 2013.

The processing shortfall this year will mean around 7.1 million carats produced by calendar year end. Looking ahead to next year, the planned production is expected to be 1.6 million tons of mined ore processed, with a further 200,000 tons processed from the stockpile, to deliver around 6 million carats during calendar 2013. This plan will receive further definition in January following review by Rio Tinto.

The development of the A-21 pipe, the last of the Diavik kimberlite pipes in the original mine plan, as been deferred due both to the diamond market conditions and decreased urgency following the identification of the extensions to the existing pipes. Although these extension areas cannot be categorized as ore at this time, due to insignificant definition work, they are expected to extend the life of the existing developed pipes, therefore deferring the need for A-21 as a source to keep the processing plant full.

Cost control has become a central focus of the mine operation. A set of four wind turbines has been installed at site and are producing around 15% of the power demand for an anticipated savings of 4 million to 6 million-liters of diesel fuel consumption over the full year. Operating costs are currently forecast to be around $420 million for calendar 2013.

The diamond market has recovered its poise after a relatively prolonged decline from the heights of 2010. It has now given back around half of the gain that was made since the 2008-2009 crisis, but is now a healthier market with credit levels and diamond stocks at all levels of the chain under much better control.

From our own perspective, we've seen strong sales in Japan and improvement in America, the two most important diamond markets, while Chinese tourists are having a big impact on sales in other centers. We do not expect rapid near term rises in rough diamond prices, but we do believe that a corner has been turned in an industry where demand is clearly poised to outstrip supply.

We've announced that we've agreed with BHP to purchase their Ekati mine and peripheral property for a total of $500 million. We are now in the middle of a period where the two individuals responsible for the discovery of Ekati may seek to exercise certain rights of refusal. Assuming that these rights are not exercised and the other conditions to closing are satisfied, we look forward to them being able to provide more information regarding Ekati and our plans for it for the future.

Finally, I'd like to formally welcome Chuck Strahl to our Board of Directors. Chuck recently retired from almost 18 years in federal politics, having served as both Minister of Transport and Minister of Aboriginal Affairs and Northern development. His experience and interest in Northern development is a welcome addition to the Board.

So thanks for listening to us. We're now happy to take your questions. Please keep in mind, though, that we are not all in the same room so I'm going to attempt to direct the questions appropriately from my end of the call.

QUESTIONS AND ANSWERS

Operator

Thank you. Ladies and gentlemen, your question-and-answer session will now begin.

(Operator Instructions)

Irene Nattel, RBC Capital Markets.

Irene Nattel - *RBC Capital Markets - Analyst*

Thanks and good morning everyone. Just focusing on the luxury brand segment, I was very interested in your comments, Frederic, about the high value transaction because I didn't see any reference to any in the third quarter and I apologize if there was, and I just didn't see it. And I would think that at this point in the fourth quarter if you were going to have any meaningful transactions, you would know about it given the nature of those. So I was wondering if you could just talk a little bit about what you're seeing in terms of your customer base for those types of transactions at this point in time and their propensity to spend or not at this point.

Frederic de Narp - *Harry Winston Diamond Corporation - President Luxury Brand business*

Well, as we talk, Irene, it's the middle of the holiday season and we are in conversations with many important clients. I can tell you many important clients at this very moment in China, in Russia, in the Middle East. We have constantly conversations with clients.

The thing I wanted to insist on is that for the first time you really have what we wanted. In the Q3, you really have all the elements coming together to realize what we're searching. 55% gross margin is a decent one from the industry and is initially the objective that I had in the five years vision, to reach in five years, that we could reach already this quarter, after 2.5 years or three years executing this strategy. I wanted to insist on that because I don't want to take you to -- tell you sometimes yes, sometimes not. Unpredictable sales.

These sales come as a cherry on the cake. A large margin already of the sales of Harry Winston worldwide is now done of core and access segments, which is not the victory but this is the right direction. So I cannot tell you about that. Sometimes you'll have some, sometimes you'll have no. I have no visibility of transactions like last year, over $40 million. I don't have that visibility at this moment but we surely have transactions pending and conversations going on with clients.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great. That's very helpful, Frederic. I wasn't suggesting for a moment that the progress that you've made is not impressive because certainly it is. Which brings me to my next question.

I think in your remarks you were talking about an expansion of the customer base. Clearly, when we're looking at bridal and we're looking at accessible, could you talk a little bit about, qualitatively, who these new customers are and regionally where are they coming from?

Frederic de Narp - *Harry Winston Diamond Corporation - President Luxury Brand business*

In Japan, where we're extremely profitable, extremely successful and where we think we are going to double our presence in the next 24 months. In Japan for example, it's always the same. The base is pretty much 80%, 85% bridal. That does not change. As we launch new collections like the Belle collection for example, more creative to them, which of course more profitable bridal collections as well, we see the success of the introduction of new collections which is really exciting, but always with the same kind of clientele base in Japan.

For the rest of the world, I'm happy to report that 60% to 70% of all clients buying the new products, shall it be watches or the charms collections or the Belle collections, are new clients. And that's terrific. Because this is what we were searching. Especially on two collections, I can report the Midnight collection and the Ocean collections are I think close to 70% of the purchasers of these watches are new clients to the brand.

Irene Nattel - *RBC Capital Markets - Analyst*

That's great. Thank you very much.

Frederic de Narp - *Harry Winston Diamond Corporation - President Luxury Brand business*

Thank you, Irene.

Operator

Okay. Thank you. Oliver Chen, Citigroup.

Oliver Chen - *Citigroup - Analyst*

Hi, guys, good morning. In terms of the opportunity at Ekati, could you speak to your interest in terms of the evolution of the synergies as you see them between the luxury division and mining as you embarked on this potential transaction? And also, Bob, should we expect the trends in terms of selling smaller size diamonds to continue in Q4 and how may that impact the average price sold and the gross margin? And I had a few questions for Frederic as well. Thanks.

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

Okay. Well, let's deal with the last one first. Yes, the stockpile (Inaudible). Stockpile of diamonds that we've got, which actually we have actually sold a significant amount of it already this week, this is the week of our last sale of the calendar year and I'm sure that we sold a substantial amount of that in the market that is more encouraged by retail off take on the polished side. So, yes, the goods that are there, that remain to be sold are higher value.

We expect to -- we anticipate selling them, basically selling them down completely by the end of our fiscal year, in other words, by the end of January. We've got another sale in the third week of January before the end of the fiscal year. There's always a work stop of course which is usually on the order of 40 million to 50 million, depending on the volume that comes down the mine, which is basically width, it's goods that are in the process of being sorted, being prepared for sale. We actually turn our goods completely in one cycle, whereas the other bigger producers actually take at least two cycles to turn.

Now, relationship of Ekati to the luxury goods division. Well, we own the luxury -- we own HWI for a few reasons. One of the reasons was the information base that it gave us on movements in the diamond market and -- which has given us while the ability to price very nimbly and also to anticipate movements.

In other words, the reason that we hold diamond stocks through the cycle, particularly in times like this, where the market has been particularly difficult, because we can -- we have the confidence given by seeing that the polished article of a particular type may be actually in demand in the market, even though the market is very sloppy in general. There are always items that are -- that have been under produced and are therefore in demand. We can kind of translate that into well, if we hold onto the rough diamond equivalent of that, we can anticipate a better price for that rough diamond in the near term.

We're not trying to be what De Beers used to be, which is running a box on the diamond market. We're not trying to do that. We're just simply trying to be nimble about holding onto articles for a couple of months if we think the price is rising. Selling the ones where we think the market might be getting softer and therefore the price, anticipating a lower price following that. That's one meaning that it's had.

We don't take many stones from the Diavik production over to the retail side, although we do -- we are doing it more often now, because Diavik has produced, from the A-154 north pipe, it's producing large, high quality stones which it didn't do before when we were only producing from 154 south and 418. So there are large gems coming through and we have elected to buy those rough diamonds from the joint venture, have them polished and sell them in the retail network.

Of course, Ekati does have more of those and because there isn't a joint venture partner on the diamond sales side, it's actually easier to contemplate taking some of those through. In particular, Ekati in the pipe that's now about to be mined in the second period of its life, which is the Misery pipe, so called by the way because it's next to a peninsula called [Plat de Misere], it's not because of the quality of the diamond production from it. But the Misery pipe contains some very intense colored yellow diamonds of a particularly good quality of yellow diamond. So there, again, there's going to be a smallish family of stones that aren't appropriate to the luxury retail business.

We have also more recently got into the business of polishing small stones, particularly for our watch business. The diamonds that are used in watches are like engineering components. The hole that they fit in is an engineered hole and they have to be exactly the same diameter. Not only the same quality, the same color, the same clarity and so on. They have to be exactly the same diameter, have exactly the same depth of pavilion and height of table and so on. So they're like an engineered component and there is a serious premium paid for obtaining parcels like that.

So we have elected to do -- to polish some of those, the stones that come from our own production that are appropriate to that, we've elected to do those ourselves. The Ekati production actually has a particularly good family of those sort of stones, without getting into details. They do produce a much bigger population of these smaller, decent quality stones that could be used for that. So that's the impacts there.

Oliver Chen - *Citigroup - Analyst*

Thanks, Bob. From a bigger picture perspective, how should investors be thinking about what they're investing in? As you think about incremental M&A on the mining side, what's the relationship between this and your organic development, the diamond retail luxury, which has been going extremely well?

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

Yes. We don't see any -- we don't have any great pressure to dispose of the diamond luxury retail business. I don't think -- it's not a particularly good time to contemplate doing that anyway but we have -- in order to purchase Ekati, we have taken on a debt facility that covers all of that, including the reclamation -- environmental reclamation bond and so on. So we don't see any -- there's no business reason really to separate these two businesses.

I had always thought that as with the evolution of time, with the HWI business getting to the point where it can stand on its own feet, that it could be separated as a separate public company, but clearly that time is not now. It still requires further investment. It still needs to get through at least another year.

We've still got basically the growth in SG&A, still taking most of the profit away as we grow the business. And that's an intentional decision. We don't want to be just sort of left behind doing a small business because that's not appropriate for a public company either. So in the fullness of time, it will certainly either become separated or else be sold to someone that can do better with it than we would be able to.

Oliver Chen - *Citigroup - Analyst*

Okay. Thanks so much. As a final question, there's been great impressive success on the luxury side. Congratulations. The growth drivers in terms of how you become more direct to consumer and the opportunity to rationalize agents, how should we think about the revenue and gross margin upside from that strategic and financial decision?

And then secondly, it sounded like SG&A spending, it's the right ROI at this point in time. Does that imply, with respect to your comments, that SG&A will grow faster than sales in the near term? I think that's what I'm hearing.

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

Over to you, Cyrille.

Cyrille Baudet - *Harry Winston Diamond Corporation - CFO*

Yes. So talk about the rationale behind the -- taking back the distribution from agents. There is two effects. I'm not going to talk about specifics, but the general terms and conditions in the industry for distribution directly to a multi-brand wholesaler is retail price minus 40%. That's a good average for the industry.

What you usually give to an agent is retail price minus 65% or 70%. So by doing a quick calculation, you can see how much additional revenue margin the direct model allows, especially in sort of a well-positioned market like Asia and Japan. Of course, with that comes the need to have your own team and your own people in the country. In some countries that was already the case.

We've always had a subsidiary in Japan, so it's not going to be very expensive for us to put together a team that is going to service the wholesalers in Japan. Some other markets we didn't have a subsidiary and we had to open, as we've announced, a sales office in Hong Kong and a sales office in Miami. They are reasonable size office with small teams, so they are not very expensive, but they add on to the SG&A. That's the direct impact of changing the model on the P&L.

The second thing is that you know when you're a very high end luxury brand that you're not going to be the key priority of your agents. They're more likely to use your name to position their business, and they're not going to focus on developing the brand and pushing the revenue as much as our own people could do. So this is the second effect is that we expect a much better visibility, much better growth rates in the markets where we act directly because we will have people that are focusing on this one brand instead of being part of a brand portfolio, serviced by multi-brand agents, staff, if you want. So that's the key element to take into consideration to understand the impact of all that.

And the second part of your question was on?

Oliver Chen - *Citigroup - Analyst*

Regarding SG&A and the near term deleverage, if it's going to outpace revenue growth in terms of how we should model it in Q4 and next year.

Cyrille Baudet - *Harry Winston Diamond Corporation - CFO*

What you can see in Q3 is that we had growth of SG&A that was above growth of sales, but it was not above growth in margin and that's really the deal here. The need for additional SG&A comes from the shift that we're trying to give to the product mix on the sales revenue. As a rule of thumb -- again, you know how the top of our sales are intransitable from one quarter to the other -- as a rule of thumb, what we would like to see is that the growth in SG&A doesn't outpace the growth in margin dollar.

Oliver Chen - *Citigroup - Analyst*

Okay. Great. Good luck for a great holiday season. Thanks, guys.

Cyrille Baudet - *Harry Winston Diamond Corporation - CFO*

Thanks.

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

Thank you very much.

Operator

Thank you. Des Kilalea from RBC.

Des Kilalea - *HSBC - Analyst*

Good morning, everybody. Bob, couple of questions on A-21. The deferral, as I understand it, you would have been starting to spend quite soon on A-21 and in the deferral would you look at maybe a different mine plan? Would that be envisioned as a new idea there. You probably can't answer this, but do you have any idea how long it might be deferred before we should be kind of thinking about you spending your share of the capital?

And then maybe a question for Frederic on China. Is there any evidence yet of which way the new leadership in China is leaning towards its view on luxury sales? We saw them canceling red carpets and lavish lunches and stuff like that. That may be kind of bad noise. Do we have any idea how these new leaders will lean towards luxury?

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

Frederic, why don't you take that one first and then I'll talk with Des on the mining.

Frederic de Narp - *Harry Winston Diamond Corporation - President Luxury Brand business*

So on the Chinese side, it's very difficult to say. We only have two salons in Shanghai, one salon in Beijing. We don't have wholesale platform as we are gaining back the control of our own destiny in mainland China. And then we are going to get started now basically, this month of November, our own distribution in mainland China. We don't have a large distribution to tell you about that.

What we've seen, though, is that we can really much judge the spending of Chinese that travel around the world and it's very, very, very good and it's still very good at all levels. It's a large majority of the sales of bridal rings we sell from our London salon, in the new Harrods salon we see Chinese importantly. The Chinese have multiplied by 20, representing 5 years at Harrods London. And it continues.

Chinese traveling around the world and exponentially -- the number of Chinese travelling is exponentially growing every year. As you know, you have more than 70 million, 80 million Chinese traveling now every year. So it continues.

Locally, we're just monitoring the sales of our salons which is a good satisfaction for beginning, for a first year. We have some high jewelry sales, we have lots of bridal sales. Overall, it's a good departure, it's a good beginning in China. I cannot answer properly your questions after the change of government here.

Des Kilalea - *HSBC - Analyst*

Thank you very much.

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

Let me deal with A-21 then. Des, at the moment, the CapEx for A-21 is seen as about $500 million. That's to do a full dike in the same manner that we've done the dikes around the other pipes. It doesn't need to happen because of the extensions that have been discovered, not discovered, the extensions that have been delineated really to the other pipes, particularly at depth, it does give additional production there. It means that you don't strand A-21 for at least another three years.

At the moment, in the plan at the moment, there is a minor amount of work being spent this year to prepare for rock crushing. One of the ways we are saving some money on A-21 is that because of the crushing capacity that was installed with respect to the base plant that was contemplated but not used, there is excess crushing capacity there and so the plan there's a generous amount of time, the required engineered crushed rock products that are needed for the dike construction can actually be done on site without having to bring in a temporary crushing set-up and a contractor to operate it. Some preparation for that is going to take place this year. It's only, I think, $11 million or something like that.

The decision that still sits in the mine plan is being made late this year. I simply believe it's a fairer way to represent this, that with Rio Tinto also looking to sell their diamond business and the time that it's likely to take for them to achieve that, that the decision is likely to be made by a new owner and not by Rio, frankly, and because there isn't a necessity to do it now. So I don't think they're going to step into a new capital project that they don't really have to. So on that basis, I see basically the decision being deferred to 2014, which was the other part of your question.

Des Kilalea - *HSBC - Analyst*

Okay. Thanks, Bob. Thanks very much.

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

You're welcome.

Operator

Okay. Thank you. Brian MacArthur, UBS Securities.

Brian MacArthur - *UBS - Analyst*

Just a follow-up on that. You make a comment that A-21 was deferred because of finding more ore but also the diamond market. But based on your last comment, it sounds to me -- let's ask the question this way. If the diamond market was better would it still be deferred? It sounds like it probably would have been.

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

Yes, I think so, probably, Brian. It's just because of the necessities in there to do it. You don't want to leave this thing stranded as the last source of production on the property. You need to be doing it along with other things, unless of course in the fullness of time, unless it gets linked up with Ekati or something like that where all of a sudden, it gives you a lot more flexibility.

As currently seen as a standalone operation, it can be deferred. So in a time when capital demands for other projects and all of the large mining companies, as you know, are under quite a lot of question and the diamond market is still not really back on its feet to the extent that we can take a reliable look into the future, I think. I think we're still in a period where there are some factors that could go either way.

Brian MacArthur - *UBS - Analyst*

As we think about this going forward, you say keep the mill full by these new extensions. We're still not filling at 2.1 million tons or whatever going forward. These new extensions, are they at least going to still keep it like in the old mine plan at 1.8 million tons every year?

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

I think that becomes a question. We still don't really know what the real limits of underground production are. Although the plan -- the plan is for 1.6 million tons mined from underground next year, the target production for the internal group here is 1.8 million. And I think we really haven't operated the underground mine on a standalone basis in the good, solid rock as opposed to the nasty ground right underneath the open pit of 418, for instance.

I think we need to get ahead of it before we really can determine the ultimate capacity of the underground mine. But there are now three haulage exits from the mine and haulage was clearly going to be the bottleneck. So I think there is -- you could be optimistic that there's going to be more than 1.6 million tons come out of the underground mine, but yet to be demonstrated.

Brian MacArthur - *UBS - Analyst*

Because that's what -- if I look back at the original mine plan for next year, you sort of had the 0.7 million tons from 154 north, that's consistent. Looks like -- I don't know if it's rounding. It's a little better on 154 south.

In A-418, looks like it's cut from 0.65 million to 0.4 million tons. Yet we talked about how things are going better than expected at A-418. So I'm kind of -- if things are going better underground than you thought, I'm surprised that we actually take it down in the near term as opposed to going the other way.

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

But it's because of being -- that's really because of being able to have access to more 154 south ore than was expected. And it's higher value. So you're always going to go -- you're always going to go for the higher value ore as long as it's consistent with keeping the eventual closure date together properly. That's really a question of displacing some ore, because 154 south is going better actually than the plan suggested.

Brian MacArthur - *UBS - Analyst*

Right. But with excess capacity in the mill, why don't you just do both?

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

Because you're not sure that you can actually haul that much out from underground.

Brian MacArthur - *UBS - Analyst*

It's a haulage thing. I would go back to the main -- the original mine plan we got when it all came out. We basically got to reconstruct those, again, to some extent, delaying A-21 and then making some decision about how all this stuff is going to ramp up, is that fair?

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

I think that is fair. I would just here again say that this plan, that I just picked this up from a joint venture meeting here in Yellowknife two days ago, it's not yet even been blessed by Rio Tinto in London. This is all happening in the context of Rio Tinto looking for a buyer for their diamond business. This is not exactly a stable platform at the moment.

Brian MacArthur - *UBS - Analyst*

With this whole thing going on, is there any -- for exploration looking for other pipes on the Diavik property, is there anything coming up for that next year or with this uncertainty is there going to be nobody looking for anything next year?

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

The exploration -- the small exploration budget there is for next year is really devoted to getting all of the information in absolutely tidy, readable, cross-referenceable form. There's no real physical work going on there. We, on the other hand, are undertaking an exploration program on the grand that we've acquired to the southwest of Diavik, along the trend from [Jay], Misery and the Diavik pipes and we are actually launching a serious over burden drilling, sampling program there starting in the spring.

Brian MacArthur - *UBS - Analyst*

Great. Thanks very much, Bob.

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

Okay. Thanks, Brian.

Operator

Thank you.

(Operator Instructions)

John Rich, JPMorgan.

John Rich - *JPMorgan - Analyst*

I had two quick questions for you. The first one is you mentioned the release last night that you're expecting slower growth in the near term which will impact the holiday season. I was wondering if you could share a little more color about what's driving that, maybe in which geographies you're seeing a change in sales trends. Is it mainly Hurricane Sandy related in the US or have you seen your consumers change their spending patterns around the fiscal cliff? And then I have one follow-up.

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

Frederic? Hello?

Frederic de Narp - *Harry Winston Diamond Corporation - President Luxury Brand business*

The comments are more for the industry because these are the industry comments coming from all over the globe, the luxury world, the hard luxury world, the efficient world. As far as we see the trend concerns for us, we continue to see robust trend for the core and access business in line with the trend we've seen the last nine months.

John Rich - *JPMorgan - Analyst*

Okay. Thank you. And then as far as tourist sales are concerned, could you share with us a little more color on what the trends there have looked like? Have you seen any change in the strength of your tour sales or has the mix of countries that the tourist sales are coming from changing? Thank you very much.

Frederic de Narp - *Harry Winston Diamond Corporation - President Luxury Brand business*

Yes, we continue to see -- the tourism is the most positive element that is existing today and will exist for the next 10 years to come in the industry. I talked about Hawaii, Las Vegas. People travel and travel more. You have 43 million new tourists every year in the world. These tourists, most of them, 60%, some statistics say, I'm not an expert but the majority of them are spenders because they have some net worth.

It's the most exciting thing on earth because our brands are positioned to be the most exclusive brand in the world, for Harry Winston, people fly to you more easily. This is what we see. The reason for us is that we have existing salons located in many tourist locations, Hawaii, Las Vegas, that benefit greatly from that, helping us have organic sales, organic growth from the existing salons. In the case of London that is booming this year, it's a salon we opened four, five years ago but this year has gone up. Basically we see the flow of tourism accelerating, coming from Japan, from China, from Russia, from Brazil and from Nigeria as well.

John Rich - *JPMorgan - Analyst*

Thank you guys very much. Good luck over the holiday season.

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

Thank you. Any further questions?

Operator

There are no further questions, sir.

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

Okay. Thanks very much. Thank you all for listening to us.

If you want to follow up, of course, I think most of you know where to find me but there's also Richard Chetwode, Laura Kiernan and Kelly Stamm available in various locations throughout the world. If you want to call them or e-mail them afterwards, we're happy to deal with any follow-up. Thanks very much.

Operator

Thank you, ladies and gentlemen. That concludes your conference call for today. Thank you for joining us and you may now all disconnect.
