

FINAL TRANSCRIPT

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HW.TO - Q2 2012 Harry Winston Diamond Corp Earnings Conference Call

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CORPORATE PARTICIPANTS

Bob Gannicott

Harry Winston Diamond Corp - Chairman, CEO

Cyrille Baudet

Harry Winston Diamond Corp - CFO

Frederic de Narp

Harry Winston Diamond Corp - CEO - Retail & Wholesale

CONFERENCE CALL PARTICIPANTS

Seth Peterson

Berenberg Bank - Analyst

Brian MacArthur

UBS - Analyst

Laura Kiernan

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Harry Winston Diamond Corporation fiscal year 2012 second quarter conference call. My name is Shantalay, and I will 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. 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 OSC and SEC filings. I would now like to turn the representation over to your host for today's call, your chairman and CEO, Mr. Robert Gannicott.

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

Good morning, everyone, and welcome to the Harry Winston Diamond Corporation second-quarter results update. I'm in Toronto with Cyrille Baudet, our Chief Financial Officer, Frederic de Narp, whose wife took Labor Day extremely seriously this year by presenting him with a new son on that day, is therefore in New York, and so he's joining us by phone.

Global retail demand, especially in the emerging economies such as China and India, has delivered both strong retail sales growth and strong rough diamond prices throughout the second quarter. Seeing through the effect of a small number of high-value, low-margin sales, our own jewelry and timepiece business has shown solid growth in both sales and margin in the core bridal, timepiece and design jewelry segment.

In the mining and rough diamond sales portion of our business, this consumer off take has been reflected in strong demand throughout the quarter. The market price increases in rough diamonds has more than compensated for 2 complete sales versus 3 in the comparable prior year quarter as well as the lower quality diamonds mine from the upper part of the current open pit and some fine diamonds recovered from the reprocessing of some of the reject material that have been stored on the site since the beginning of the project.

I'm now going to hand the call over to Cyrille Baudet, our CFO, who's going to explain the financial results. Cyrille?



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Cyrille Baudet - Harry Winston Diamond Corp - CFO

Thank you, Bob, and good morning, everyone. I've been here 4 months and I've spent a lot of time developing my understanding of the Harry Winston business. I've been meeting with investors, with team members and our board members. I've traveled to many of our locations and see a lot, and I'm very, very impressed by what I've seen.

I would like to discuss our consolidated and segment operating results for the quarter. The Company's consolidated results for the second quarter delivered total sales of \$222.4 million, up 45% versus the comparable quarter over the prior year. This increase in the quarter was largely driven by higher luxury segment sales.

Mining sales during the second quarter were \$89.6 million, an increase of 3% versus the prior year. Sales were impacted by an increase in achieved rough diamond price per carat of 41%, offset by a 27% decrease in the volume of carats sold versus the comparable quarter of the prior year. The decrease in volume of carats sold was the result of having completed only a portion of sales in the quarter versus 3 full sales in the second quarter of prior year. The 41% increase in achieved rough diamond price per carat would have been higher, but for a much higher portion of the sales mix coming from the lower value A418B ore versus the comparable quarter of the prior year.

The Diavik mine produced 1.8 million carats, an increase of 11% during the second calendar quarter compared to 1.6 carat in the comparable quarter of the prior year. Diavik's full-year target remains at an estimated 6.9 million carats. Luxury brand sales of \$132.8 million increased 98%, or 81% on a constant dollar basis, during the second quarter versus last year. Even when we exclude the exceptional high-value transactions of \$55.6 million, growth in sales was still strong at 15% versus the prior year. Bob and Frederic will expand on the segment sales. Our consolidated gross margin percentage of 32.5% in the second quarter was below prior year of 44.2%.

The mining segment gross margin decreased to 24.5 in the second quarter from 37.3% a year ago. The mining segment gross margin is impacted by a greater volume of production coming from the higher cost underground mining. Underground mining costs are of course higher than open pit costs, and there is the additional effect of the early underground ore being mostly sourced from development work rather than production scale stopping. Finally, underground production incurs higher depreciation costs as the capital of building and infrastructure begin their depreciation schedule.

The luxury brand gross margin decreased to 37.8% in the second quarter of 2012 from 53.1%. Gross margin for the quarter was lower than last year, driven mainly by the mix of high value jewelry sales that carry a lower than average gross margin. As Bob mentioned, excluding these transactions, our salon sales of jewelry and timepieces have shown solid growth driven by favorable mix, bridal, Lily collection and timepieces in retail.

We have been negatively impacted by the strength of the Swiss franc as all the Swiss producers have. As has occurred throughout the watch industry the stronger Swiss franc has resulted in increased prices for watch products.

Consolidated SG&A in the second quarter increased by \$11.1 million, or 29% to \$49.1 million versus last year. SG&A increased by \$0.9 million in the quarter for the mining segment, due mostly to higher mark-to-market stock based compensation and to the strengthening of the Canadian dollar. SG&A increased by \$10.2 million, or 31% in the quarter for the luxury brand segment. As a percentage of sales, SG&A decreased to 33% of sales versus 50% in the prior year quarter. The increase in spending during the quarter on the luxury side was primarily driven by new product launch expenses for Midnight and the Lily Cluster collection, higher variable compensation expenses resulting from higher sales, and increased rent and building related expenses. This resulted in consolidated operating profit of \$23.1 million in the quarter versus \$29.9 million a year ago.

When excluding depreciation and amortization, consolidated EBITDA was \$43.8 million versus \$49.4 million a year ago. Consolidated financing expenses were higher in the quarter primarily due to the higher debt balance for the mining segment versus a year ago that resulted from the Kinross buyback transaction. Consolidated earnings per share attributed to shareholders

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in the quarter were \$0.12 versus \$0.17 in prior year. Our liquidity at July 31 was strong with cash balances around \$140 million. Our availability under our credit agreement of \$119 million. On August 25, we paid the \$70 million Kinross promissory note plus accrued interest of [\$3.5] million from cash on hand (company corrected after call). So, as we paid the \$70 million Kinross promissory note plus accrued interest of [\$3.5] million from cash on hand (company corrected after call).

In May, we announced our intention to partner with Diamond Asset Advisor on a diamond fund. The fund is expected to run the first capital subscription of approximately \$100 million from investors later in this fiscal year, with the remaining \$150 million expected to be raised over the following year subject to market conditions. I will now hand over to Frederic de Narp, the CEO of Harry Winston Inc. who will discuss the results of our jewelry and timepieces business.

Frederic de Narp - *Harry Winston Diamond Corp - CEO - Retail & Wholesale*

Thank you very much, Cyrille. I would like to characterize this quarter by saying it was exceptional in terms of sales performance. As Cyrille mentioned, our profit was very good, exceeding that of prior periods. These results were driven by the successful execution of our strategy, as well as solid demand for hard luxury goods during the quarter. Our team has continued to do an excellent job of executing against the strategy of Harry Winston Inc. this quarter by following through with an impactful integrated marketing strategy including new advertising, promotions, public relations, new store designs, exceptional new products both in jewelry and timepieces by also opening 10 new wholesale watch doors.

We also had success in developing our higher-margin more predictable lines of business including bridal, jewelry collection and timepieces. This contributed to profitability in both dollars and margins, but the effect of the improved margins for our core Salon products was overshadowed by the impact of several lower margin high jewelry sales. As you saw in our results, we posted a sales figure for Harry Winston Inc. of \$132.8 million, nearly double last year's sales for the same period. We did disclose that we made several high value transactions during the quarter totaling \$55.6 million. Excluding these high-value transactions, our sales still increased by 15%. On a constant exchange rate basis, our sales increased 81% in the second quarter and increased 48% for the first half of the year versus the prior year. Our full-year sales growth objective is a minimum of 15% with improved operating profit and EBITDA versus last year. I will talk about our long-term outlook after I cover off on our regional results.

On a regional basis and at a constant exchange rate that has increased by 38% in the US, 11% in both Europe and Japan and by 390% in Asia, excluding Japan. All US salons benefited from our integrated marketing programs, including the new product launches of the Lily Cluster jewelry collection and Midnight watch collection, as well as increased advertising for Harry Winston brand jewelry and timepieces. Increased tourism in the US also benefited these salons.

In Las Vegas, we believe the new Sofield store design, better retail location in Crystals -- at Crystal Center in Las Vegas, as well as increased traffic from abroad all contributed to higher sales. This gives us confidence in the new store concept and should support our future rollout plans.

In Europe, sales increased 11% at constant exchange rates. Similar to the US, the Paris and London salons benefited from the integrated marketing campaigns and new product launches as well as increased overseas shoppers. We are under represented in Europe from a salon network standpoint, so as we grow the number of European salons in coming years, we believe sales will grow at a faster pace than the overall hard jewelry market. Our timepiece business is growing as expected, and we are optimistic about the holiday season.

In Japan, sales increased 11% at constant exchange rate, supported by the successful launch of the new Lily Cluster jewelry collection and continued strength in our bridal business. In Asia, outside of Japan, sales increased 390% at constant exchange rates. The long-term trend of rapidly growing wealth in the emerging markets led by China continues to provide strong demand for our jewelry and watch products.

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I personally wish to congratulate all of our associates around the world on the great performance this quarter and year-to-date. In terms of our longer-term outlook, we are executing on the global expansion of our distribution network through new salons opening, licensed salons and wholesale watch distribution.

Our primary focus is in Asia, the Middle East, and Europe. Regions where we see opportunity to expand the brand over the next few years. This is supported by expected strong global wealth trends. We plan to open 2 new licensed to salons in Dubai in November and 1 in Russia in December, ahead of the holiday season. We will open a new owned salon in Shanghai between December and January and the Shanghai flagship store in February or March of next year. We have several other salon openings planned for next year.

Similar to Europe, we are underrepresented in Asia. There are significant opportunities to grow our business in this region and build further awareness of the Harry Winston brand. Consumers are traveling in increasing numbers, especially from China, benefiting our salons located in prime cities throughout the world. We expect to benefit from Chinese client cultivation over time, especially once the flagship Shanghai store is open and we implement our marketing program there. We are optimistic about global timepiece sales and plan further new product launches in the third quarter, including the new Ocean Sports collection.

We continue to remain on track and even ahead of plan for our 5 years vision. As most of you are aware, our objectives over the next 5 years are to increase our distribution network to 50 salons, a minimum of 50 salons and 350 wholesale watch doors around the world. We will maintain a commutative annual growth rate on top line sales of a minimum of 15%. We will improve our gross margin to the low to mid-50s and grow a -- and we will grow operating profit margins from 4% last year to low to mid double digits. Our longer-term goals for between 7 and 9 years are to grow Harry Winston Inc. to \$1 billion in sales with a minimum gross margin of 55% and an operating margin of 15%.

One of the challenges we face this year will be to continue this strong sales growth we experienced last year. It becomes increasingly difficult to grow sales at a similar rate as we progress through the year. Sales of high jewelry will vary from quarter to quarter as we work to grow the more predictable and higher large margin lines of business, including watches, jewelry collections and bridal. We encourage you to track our results on a trend basis over time. We are committed to the high jewelry and high complication timepieces business while at the same time building our other lines of business. We will continue to build on the strong trusted heritage of Harry Winston remaining the world's most exclusive branded jeweler. We are confident that we will achieve our goals for this year and beyond. Despite the current economic uncertainty, we continue to remain optimistic regarding the luxury retail market

I will now hand the call back to Bob.

Bob Gannicott - Harry Winston Diamond Corp - Chairman, CEO

Thank you both. The Diavik Mine continues its transition from open pit to underground mining with an important milestone at the end of the quarter being the successful extraction of the first production from the new sublevel retreat method in the A154 south pipe. This method, to be deployed in both the A154 south and A418 kimberlite pipes, is significantly cheaper and higher velocity than the originally planned methods using cemented backfill. A new mine plan, both for the near term and life of mine, is nearing completion with the first review to be next week. We expect to be able to share this with you during this next quarter. Mine planning, of course, is an ongoing process and modifications to ore haulage, ventilation and development plans, et cetera will continue throughout the next 6 months to add improvements as the mine becomes more reliant on underground ore sources.

The rough diamond market has seen an exceptional price growth during the quarter fueled by Asian demand for the finished products. The disturbance in the financial markets in early August led to an abrupt pause with jewelry and timepiece sales stalling for a brief 10 day period. In our own jewelry stores throughout the world, this interlude passed as quickly as it had begun,

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and August sales in fact recovered to meet expectations. Since we understand this to be the general experience of international jewelry and timepiece businesses, we would also expect the rough diamond market to recover its poise during the coming quarter.

Looking forward, we continue to see strong global jewelry and timepiece demand from China while Japan and the Middle East improve and the US and Europe remain subdued. On this basis, we expect to continue to grow our jewelry and timepiece business despite challenging economic conditions in the US and Europe. Although we are not predicting further near-term rough diamond market price increases, we do expect our own rough diamonds mix and therefore prices to improve as an increased proportion of production is sourced from the higher value A154 south and north pipes. The new production plan for the Diavik mine is expected to incorporate the new mining methods as well as bringing the A21 kimberlite into the production schedule. We look forward to sharing this you once it's been fully baked.

We're now happy to take your questions. Thank you.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Your first question comes from the line of Seth Peterson of Berenberg. Please proceed.

Seth Peterson - Berenberg Bank - Analyst

Thank you. Good morning, and congratulations on some stellar sales growth. I have three questions, perhaps the first one for Bob and then the other two for Frederic. Bob, would you be able to give us some indication of how much cheaper the sublevel retreat's mining method is, or will that be included in the updated mine plans?

Bob Gannicott - Harry Winston Diamond Corp - Chairman, CEO

That's for the updated mine plan. I don't think there's any point in trying to guide you towards that because we don't really have a number in our head yet. I'm going up to a meeting up in Yellowknife, leaving tonight, the meeting is most of next week. And we'll certainly come back properly when we've got something that we can rely on.

Seth Peterson - Berenberg Bank - Analyst

Thank you. And Frederic, would you be able to give us what the currency adjusted sales growth for the division would have been excluding the exceptionals?

Frederic de Narp - Harry Winston Diamond Corp - CEO - Retail & Wholesale

I think that's probably better handled by Cyrille, but --

Seth Peterson - Berenberg Bank - Analyst

Okay.

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Cyrille Baudet - *Harry Winston Diamond Corp - CFO*

If you exclude the exceptional sales and if you look at the performance quarter over quarter at constant dollar basis, we show growth in sales of 6%.

Seth Peterson - *Berenberg Bank - Analyst*

6%, okay. And then if I heard correctly, Frederic, did you say you have a new Ocean Sports timepiece that's coming out?

Frederic de Narp - *Harry Winston Diamond Corp - CEO - Retail & Wholesale*

Yes, we are presenting -- we are embarking onto the delivery of the Midnight collection we started in June. That's the new big pillar of the timepiece collection. And the other one is actually this new Zalium sport collection which is an even more aggressive in term of price. It is a collection at the Ocean Sports addition between \$15,000 and \$25,000 at retail. It is an entirely Zalium collection which is -- the Zaliumis zirconium alloy patented by Harry Winston that only Harry Winston can use, and it is an entire new sports line, we are starting delivery at the end of September.

Seth Peterson - *Berenberg Bank - Analyst*

Okay. Thank you very much.

Frederic de Narp - *Harry Winston Diamond Corp - CEO - Retail & Wholesale*

Thank you.

Operator

Thank you. (Operator Instructions). Your next question comes from the line of Brian MacArthur of UBS Securities. Please proceed.

Brian MacArthur - *UBS - Analyst*

Good morning. I was just wondering if I could get a little more detail on the value per carat in each of the sections of the pipe. For 154 south, the price was \$165 in May, \$180 in June. And now you're saying, for example, \$200 is what you're using to model going forward. Is that \$200 what you got in July, is that \$200 what's going to be used in the feasibility study, or is that \$200 what you believe the carats in that specific pipe would work out over the mine life? What exactly -- it's kind of hard for us to backtrack given the mix and match as to the revenue exactly what those numbers are.

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

Let me weigh in there, Brian, because first of all, there isn't a feasibility study. We're getting a mine plan. The mine plan that doesn't include estimates of diamond price because we intend to do ourselves have diamond prices because we sell differently. So, the mine plan is -- will focus on -- what we'll be able to deliver is the forecasted ore mix, the ore release schedule, and cost, of course. In terms of price, the numbers that we have in there are actually the average for the quarter.

Laura Kiernan

Yes. The \$200 for the month of July specifically.

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Bob Gannicott - Harry Winston Diamond Corp - Chairman, CEO

It was the July sales. We're not making a prediction about what it is going forward. That's what it is now, as of the last sale. The way the prices are derived is by each pipe has a unique size distribution; in other words, there's a unique ratio of different sizes of diamonds that make up the overall mix at each pipe so that we're able to therefore to create these price per carat for each pipe.

Brian MacArthur - UBS - Analyst

Right. This is a point in time effectively, if we were to see -- you don't expect, no weakening diamond prices, that \$200 to could go back down or whatever. So, it's really just July sales prices is what it represents?

Bob Gannicott - Harry Winston Diamond Corp - Chairman, CEO

Right.

Brian MacArthur - UBS - Analyst

And just out of curiosity, I know it's a super high margins, so it probably doesn't matter, when they do the ore release in determining which is reserve and sterile ore, they must use some price for the diamonds to determine what's economic or not economic. Are you saying this stuff that's in there was done at such a lower price compared to where we are today, is there really a relevant ore? Is there a lot more ore that's going to come in because of these higher prices when they do their tonnage coming out of each of the pipes?

Bob Gannicott - Harry Winston Diamond Corp - Chairman, CEO

As you know, kimberlite pipes are very discreet bodies. It's not as if there is a fading grade as you come to the edge of the pipe, there's just an abrupt boundary from kimberlite into barren granite or metamorphic rocks at least. All of the kimberlite that's in the ore reserve and resources actually comfortably exceeds any mining costs at the moment. Certainly, the kimberlite in the business plan is all well above the bar of profitability.

Brian MacArthur - UBS - Analyst

Right. So, then this plan will -- let me word it a differently -- will only effectively give you the ore release schedule for the material end reserves in the four pipes right now. But obviously, as these prices go higher, they can probably go deeper. None of that will be factored in, so ie., in year 2017, we wouldn't supplement lower grade A154 ore with maybe higher A154 north ore at depth or something like that. This plan is not going to have that sort of mix in it. It's only going to be based on what you know today

Bob Gannicott - Harry Winston Diamond Corp - Chairman, CEO

Well, no, it will take a forward view as well. Really, I suppose what you expect to see is obviously A154 will deplete the fastest because it's highest grade' and it doesn't go to the same depths as either A418 or 154 north. Because of the open sky sublevel retreat method applied to A418, it can also be mined faster. So, the latter days of the mine will be a combination of ore from A154 north where there'll be cemented rock backfill used, so therefore slower mining method, but very high value diamonds, combined with open pit production from A21. Without being -- without getting dates and formal numbers on ore release schedule, that's the way that the plan will evolve.



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Brian MacArthur - UBS - Analyst

Great. Thanks very much, Bob.

Bob Gannicott - Harry Winston Diamond Corp - Chairman, CEO

Thanks.

Operator

At this time, there are no further questions in the queue.

Bob Gannicott - Harry Winston Diamond Corp - Chairman, CEO

Okay. Thank you very much.

Cyrille Baudet - Harry Winston Diamond Corp - CFO

Thank you, everyone.

Frederic de Narp - Harry Winston Diamond Corp - CEO - Retail & Wholesale

Thank you.

Operator

Thank you for your participation in today's conference. This concludes the presentation. You may now disconnect. Have a wonderful day.

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