Dominion Diamond Corporation (DDC: NYSE)

Financial Analysis By: Issam Kaisse – Basic Materials

Company Profile as of 02/14/2015

Market Price: $16.55
Industry: Nonmetallic Mineral Mining
Market Cap: 1.41B
52-Week: $11.81 - $18.50
Beta: 0.68

Source	Target Price	Recommendation
Siena	$18.70	BUY
Bloomberg	$20.22	BUY
Capital IQ	$21.40	OUTPERFORM
Yahoo Finance	$20.14	BUY

Thesis

-Attractive Fundamentals
-Production expansion
-Strategic acquisitions and alliances
-International Expansion and Opportunities

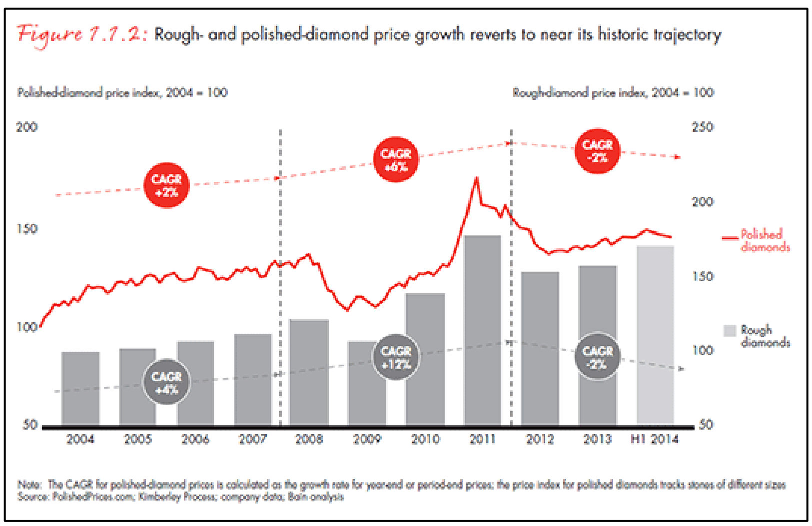
As the price of rough diamonds prices are expected to increase by 2018, Dominion Diamond Corporation (DDC) is a company well positioned to benefit from the growing appetite for these precious stones. DDC is a buy at the current price of $16.55 and has a target price of $18.70, a potential upside of 13%. The stock is considered undervalued despite savvy financial management and strategic acquisitions that will enable the company to be the third largest producer of rough diamonds in the world. Dominion Diamond Corporation is well positioned to supply fast growing market for diamond jewelry sales in countries like China and India. Also, the increasing diamond output for DDC and lower oil prices will give the firm a competitive advantage and improve margins starting 2015. Overall, Dominion Diamond Corporation is a hidden gem because it has ownership interests in two of the world's most valuable diamond mines in Canada with political risk environment.

Company Overview

Dominion Diamond Corporation focuses on the mining and marketing of rough diamonds worldwide. DDC is a Canadian diamond mining company with ownership interests in two major producing diamond mines situated in Canada's Northwest Territories. The firm operates the Ekati Diamond Mine with an 80% ownership and maintains 40% of the Diavik Diamond Mine. DDC supplies rough diamonds to the global market through its selling operations in Canada, Belgium and India. The company was formely known as Harry Winston Diamond Corporation and changed its name in March 2013 after it decided focusing on diamond production as well as selling jewellery stores to Swatch Group of Switzerland last year. Dominion Diamond Corporation does not operate the Diavik Diamond mine. The mine is operated by Diavik Diamond Mines Inc., a subsidiary of Rio Tinto, one of the largest and most highly regarded mining companies. Under the joint arrangement, Rio Tinto operates the mine and Dominion Diamond pays 40% of the mine's operating and capital costs while receiving 40% of the mine's diamond output. DDC is keen to buy control of Canada's Diavik mine from Rio Tinto if the global mining group is ready to sell its diamonds business.

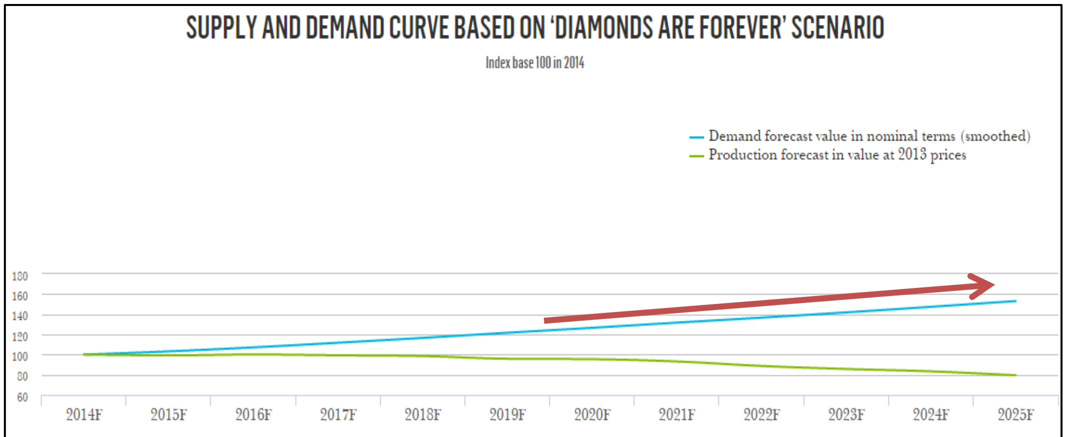
Industry Outlook

Starting 2013 the diamond market started to show signs of sustainable growth and developments in the diamond industry. The global production of rough diamond in 2013 jumped by 7% over 2012 levels and consumer demand continues to increase every year and there is a clear opportunity growth. The diamond value chain posted solid growth since demand from countries like China and India is constantly growing. As we can see on the graph below, prices of both rough and polished diamonds show moderate growth in the first half of 2014.



According to McKinsey & Company's report[1] it is expected that diamond prices are going to rise by 5.5% per year over the next 5 years. The report also signals that demand will outpace supply over the next 5 years and projects the rough diamond demand to grow by 5.8% per year over the next 5 years. Demand for rough diamond has recovered significantly since 2012 because the US is leaving the crisis behind and we are seeing pre-2008 levels again. China and India are also experiencing rapid growth in the rough diamond market because there is an important middle class with improving consumer confidence.

[1] http://insightreport.debeersgroup.com/diamond-industry-outlook/index.html



Source: De Beers analysis, McKinsey & Company, 'Perspectives on the Diamond Industry', September 2014

Attractive Fundamentals

Dominion Diamond Corporation is well positioned financially and keeps improving its fundamentals versus its competitors. The company has a strong balance sheet before even taking advantage of the acquisition of the two of the richest producing diamond mines in the world. As the firm slide below indicates, DDC keeps looking for ways to improve its financials.

Fiscal Year 2015 – Third Quarter (in millions of US dollars except where otherwise noted)	
Opening net cash at July 31, 2014	**384.0**
Cash flow from operations for the period	72.3
Capital expenditures for the period (net of Misery pre-production revenue)	(22.8)
Cash tax paid for the period	(1.2)
Net interest paid during the period	(0.5)
Acquisition of additional interest in Ekati	(27.5)
Other	(3.5)
Closing net cash at October 31, 2014	**400.8**
FCF[1] generated during Q3 fiscal 2015	**35**
Debt	46
Diamond Inventory at October 31, 2014	
At cost	235
Estimated market value	**350**

We can clearly see a strong growth potential in this Canadian firm because it has the financial ability ahead of the development of some interesting projects such as Jay project and A21. In fact, the company held $289 million of cash and cash equivalents and $112 million of restricted cash as it wants to develop its mines and secure itself from any financial instability that could occur from the pull back in credit available to the diamond industry from banks. Also, the company has a diamond inventories with a market value of $350 million since they believe that the price of rough diamond will increase in the coming quarters and it is more beneficial to help precious diamond when the price becomes attractive. From a cash flow perspective, DDC was able to generate a consolidated free cash flow of $35 million for the Q3 of 2015 because its existing mines produced high quality carats that increased the revenue. Since the company has enough cash, it allows itself to increase its stake in several mines. As a matter of fact, DDC purchased an additional 16% of two Ekati zones from Chuck Fipke for a total of $70 million. Thus, the sufficient capital on hand will enable the company to fund its capital expenditures and pay its small amount of debt that does not exceed $46 million each year.

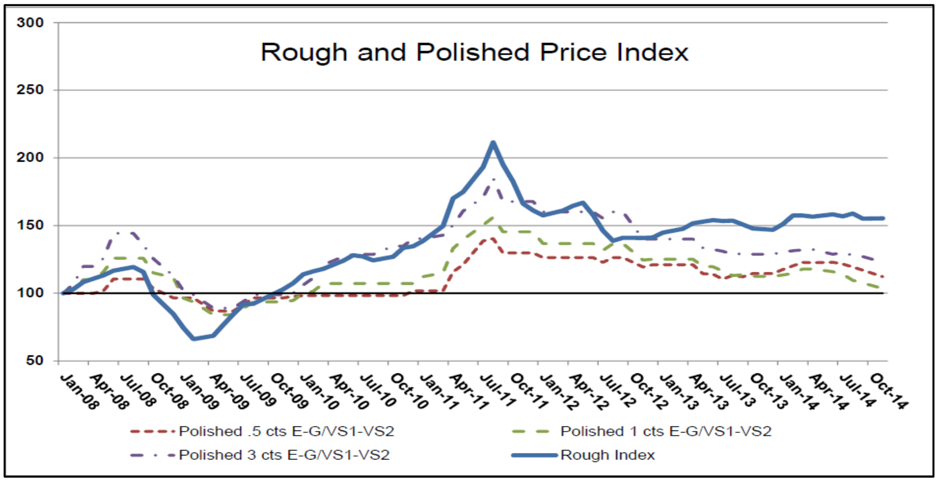
	Q3 2015	Q3 2014	YOY Change	Q3 YTD 2015	Q3 YTD 2014	YOY Change
Sales[1]	**222.3**	148.1	50%	**675.2**	518.8	*+30%*
Cost of Sales	**147.0**	136.2	8%	**505.9**	448.8	*13%*
Gross Margin (%)	**33.9%**	8.0%	+2590bp	**25.1%**	13.5%	*+1160bp*
Selling general & administration	**7.9**	7.4	+7%	**24.7**	39.3	*-37%*
Operating profit from continuing operations[1]	**67.5**	4.5	+1397%	**144.6**	30.6	*+372%*
Cash Costs of Production[2]	**121.7**	128.7	-5%	**365.0**	322.0	*+13%*
EBITDA from continuing operations[2]	**115.4**	36.5	+216%	**294.6**	115.5	*+155%*
EBITDA Margin (%)[2]	**52%**	25%	+2700bp	**44%**	22%	*+2200bp*
Earnings per share	**0.30**	(0.06)	631%	**0.78**	(0.18)	*539%*

Sales of DDC increased from $148 million in Q3 of 2014 to $222 million in Q3 of 2015 because the company was able to improve its production and carat extraction. Dominion Diamond is constantly trying to decrease its cost of sales as well as SG&A expenses against peer companies because they are increasing their energy efficiency with new operating approaches such as generators, heat exchangers, and incinerators. Also, DDC continues to improve margins at both production and sales levels as it believe it is the only way to attain its growth potential. Thus, EBITDA for this quarter was $115 million compared to $37 million for the same period last year. The company expects to recover quality rough diamonds from its existing mines in early calendar 2016 and the future looks bright with attractive projects beyond 2019 that will improve the companies' fundamentals. DDC expects a positive fourth quarter because it is the main period for consumption in the world's biggest market, the US. In fact, diamond shops and manufacturers restock their inventory during that period because they are anticipating a positive demand for jewelry. On its recent earnings call, the management team announced to initiate a dividend as they want to send a positive note to the stakeholders that they can both fund their expansion plans for the business as well as sustain regular distribution to their shareholders.

Production Expansion

Dominion wants to start building a new jay pipe at its Ekati mine in the summer of 2016. The Jay project would add 10 years to the mine and is expected to open in late 2019 when the reserves at the existing Ekati operation run out. Currently, the firm will use a pipe called Misery in 2016 until the Jay pipe is achieved. The company sees the Jay pipe as a large scale development asset because in its feasibility study of January 2015 the CEO stated "completing this pre-feasibility study is an important milestone for Jay, a project that we hope will be a significant growth opportunity for the company"[2]. Throughout the feasibility study, DDC expects the Jay pipe to contain more carats of diamonds than any pipe mined at Ekati so far. Hence, the firm will be able to generate a profit of approximately $148 million with an average diamond price of $86 per carat. As you can see on the graph below, there is a huge potential increase in rough diamond prices and DDC will benefit from this prospective increase that could attain nearly the $150 range. As a matter of fact, this acquisition of Ekati mine is important because in 2012 a 78 carat diamond was sold for $6 million. The feasibility study signals that this Jay pipe project has a positive NPV of $113 million and an IRR of 21%. Those elements show the growth opportunity for the company and the long term benefits for Dominion Diamonds will be greater with the Jay project.

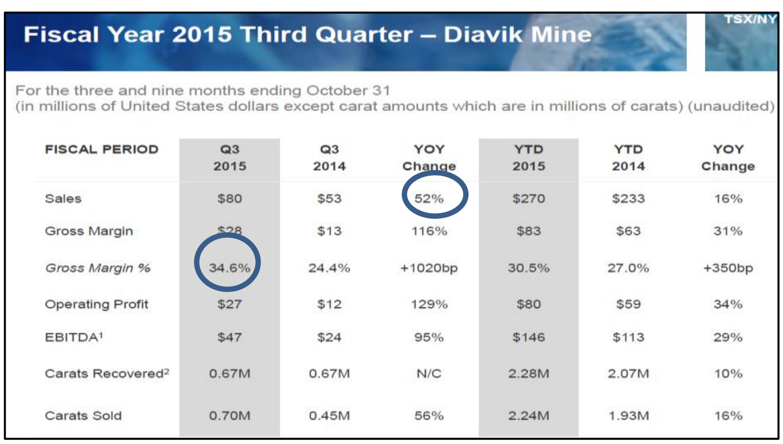
[2] http://www.businesswire.com/news/home/20150127005193/en/Dominion-Diamond-Corporation-Announces-Jay-Project-Pre-Feasibility#.VODj9vm-0yo



Another project that Dominion is eager to develop is the A21 pipe. In fact, this project will resolve the uncertainty surrounding Diavik mine, where Rio Tinto and Dominion has a joint venture partnership. The A21 pipe is expected to start late 2018 and the expansion will ensure output at Diavik sustains at existing levels. Rio Tinto is the one that will construct the pipe and Dominion Diamonds Corporation will share the profit. According to the chief executive of Rio Tinto "our decision to invest in the Diavik A21 project reflects our strong confidence in the diamond sector"[3]. DDC is constantly trying to fully acquire Diavik mine from Rio Tinto as it is near Ekati mine and will enable the firm to create synergies between both of them. Last year Rio Tinto cancelled the talks when Dominion did not agree to purchase its diamond mine in Australia as part of the deal.

Strategic Acquisitions and alliances

There is no surprise that Dominion Diamond Corporation is the third largest diamond producer by value. As a matter of fact, the company has realized strategic alliances by buying 40% stake in the Diavik mine, operated by Rio Tinto, and by purchasing the Ekati mine from BHP Billiton. Thus, the company has interest in two major Canadian diamond mines that could allow it to improve its financial situation versus its competitors. Dominion Diamonds' two mines helped the company earn approximately $498 million in profits last year and they are expected to be producing until 2022 with more than 50 million carats of reserves. Those strategic acquisitions and alliances show the financial ability of the firm to grow and improve its production. Hence, DDC does not need large capex budget in order to improve the production of its mines; however, the company needs to sustain capital if it wants to remain competitive in the diamond industry. The company will not face any risk of idle production because the mines are located in a politically stable environment. The firm considers Diavik a free cash flow generator of approximately $175 million because a feasibility study proved there are 46 million carats in reserves that will achieve profitability for DDC. The gross margin of Dominion Diamond increased from Q3 2014 to Q3 2015 by 42% and sales improved by 52% for the same period.



Fiscal Year 2015 Third Quarter – Diavik Mine

TSX/NY

For the three and nine months ending October 31
(in millions of United States dollars except carat amounts which are in millions of carats) (unaudited)

FISCAL PERIOD	Q3 2015	Q3 2014	YOY Change	YTD 2015	YTD 2014	YOY Change
Sales	$80	$53	52%	$270	$233	16%
Gross Margin	$28	$13	116%	$83	$63	31%
Gross Margin %	34.6%	24.4%	+1020bp	30.5%	27.0%	+350bp
Operating Profit	$27	$12	129%	$80	$59	34%
EBITDA[1]	$47	$24	95%	$146	$113	29%
Carats Recovered[2]	0.67M	0.67M	N/C	2.28M	2.07M	10%
Carats Sold	0.70M	0.45M	56%	2.24M	1.93M	16%

Also, Ekati delivers improvements for DDC as it generates gross margins of approximately 34% in Q3 FY2015 and increases the sales of the company by nearly 49%. Thus, Dominion Diamond will begin improving its situation thanks to two of the richest producing

[3] http://www.bnn.ca/News/2014/11/27/Rio-Tinto-approves-Arctic-diamond-mine-expansion.aspx

diamond mines in the world. This mine is crucial for the firm since there are more diamonds to extract with the potential growing demand from jewelry store and manufacturers starting 2015.

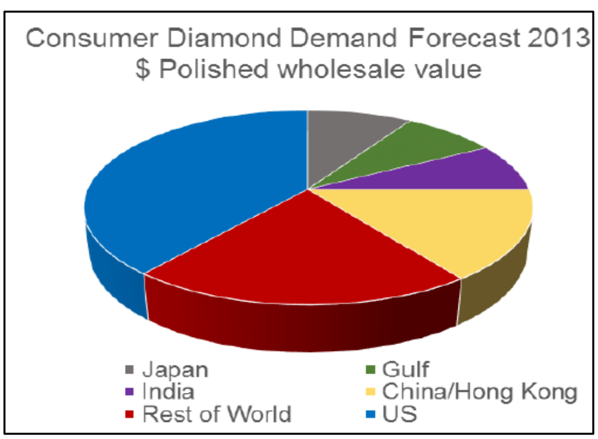
Fiscal Year 2015 Third Quarter – Ekati Mine

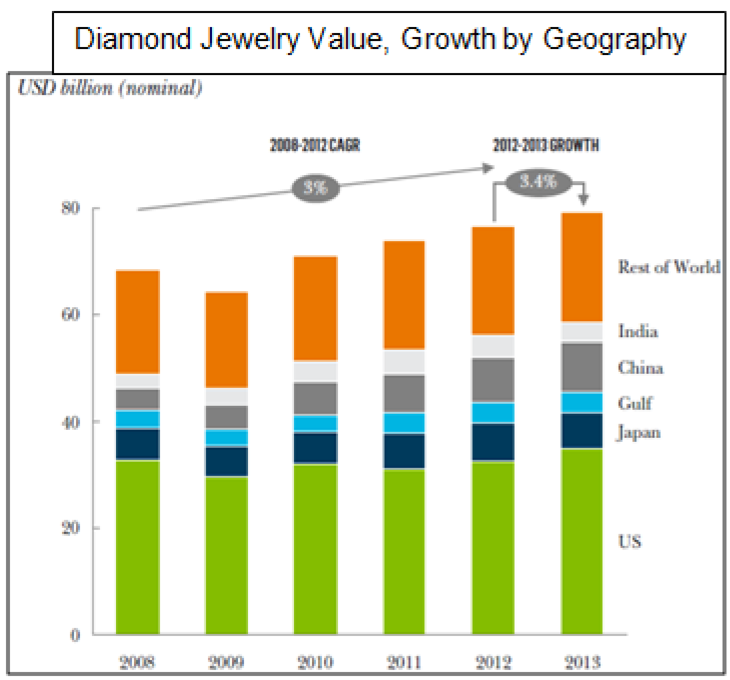
For the three and nine months ending October 31
(in millions of United States dollars except carat amounts which are in millions of carats) (unaudited)

FISCAL PERIOD	Q3 2015	Q3 2014[1]	YOY Change	YTD 2015	YTD 2014[1]	YOY Change
Sales[2]	$142	$95	49%	$405	$286	42%
Gross Margin (loss)	$48	$(1)	NM	$87	$7	NM
Gross Margin % (loss)	33.5%	(1.0)%	NM	21.4%	2.5%	NM
Operating Profit	$47	($1)	NM	$84	$6	NM
EBITDA[3]	$74	$18	317%	$167	$35	373%
Carats Recovered	0.98M	0.61 M	60%	2.34M	1.17M	99%
Carats Sold[4]	0.46M	0.37 M	25%	1.27M	0.97M	31%

International Expansion and Opportunities

Dominion Diamond Corporation is looking for the opportunity to expand its operations in countries other than the U.S. and Canada. The retail markets in both India and the Middle East recovered in the second half of 2014, and the company is looking forward to go overseas in order to improve its competitive advantage. DDC already sells its beautiful stones to manufacturers within the world's major diamond centers such as Belgium, Antwerp, and Mumbai. As the firm sees increasing consumer diamond demand from several countries all over the world, it wants to look for potential countries that will enable it to remain in the top three largest producers of rough diamonds in the world. Dominion Diamond provides desired carat sizes to more than 50 global customers outside the U.S. and Canada, which means that there is an opportunity for an international expansion. Also the company creates customer loyalty and offers an inventory guarantee to its customers in order to eliminate their need to sell unwanted stones. The two mines that DDC owns are internationally recognized as a world-scale supplier of top quality rough diamonds and the firm needs to use this as a way to improve its international exposure. As you can see on the diagram, diamond jewelry value is expected to growth in most of the countries around the globe in the long term. Thus, Dominion Diamond Corporation could benefit from this potential growing demand with an expected increase in prices starting mid-2015.





Best case/worst case

Regarding Dominion Diamond Corporation share price, there are three outcomes that could occur:

I am being conservative if the company cannot take advantage of the two largest mines in the world and the price of rough diamond remains flat in the $90 range. Thus, I believe that if the share price remains in the $16-$17 range in the next few months it means that the company was not able to deliver the promises that it stated in the latest earning calls or 10K before it starts its prospective projects.

I am being neutral if DDC does not extract high quality diamonds that could increase the demand from countries all over the world. The neutral range is between $15 and $16 because I believe that the company has what it takes to improve its position within the industry and become the top producer of rough diamonds.

I am being optimistic as DDC has a strong balance sheet with positive free cash flow and those elements enable the company to acquire additional shares in top mines. Hence, diamond companies will benefit from the potential increase in diamond prices and growing demand. I initiate my buy recommendation at the $16 levels and according to my estimates and assumptions Dominion Diamond Corporation will attain $19 through its projects that will kick start in 2019.

Conclusion

Overall, Dominion Diamond Corporation owns two of the richest producing diamond mines in the world. The experienced management team is confident that the company will be able to improve its fundamentals because it has a strong balance sheet to fund capital expenditures and sustain its credit line commitment. Dominion Diamond appears to be undervalued and investors should not ignore the potential that it could bring in the long term with its profitable projects. Those projects will give the firm the ability to improve its production and would add 10 years to the mine. Thus, the Jay project seems to present an interesting prospect for the company as it will prevent closure of the Ekati mine in 2019. Also, the A21 project gives a positive perspective for the firm because it will ensure the continuation of existing production levels for Diavik mine. The transition from being a jewelry shop to a mining company will certainly give DDC a bright future and the company keeps improving its financial results with its strategic partnerships. Dominion Diamond Corporation will start creating value when its projects start to be finalized and give it a competitive edge versus its competitors. Also, the company will experience a growth between 20% and 15% because the latest additional acquisition of Ekati will improve the production of rough diamonds. Starting 2019 the firm will keep its growth in the 15%-10% range as the projects Jay and A21 will be completed.

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Dominion Diamond Corporation	DDC	Analyst	Current Price	Intrinsic Value	Target Value	Divident Yield	Target Return	NEUTRAL
		DJ SAM	$16.40	$18.08	$18.72	0%	14.14%	

General Info

Sector	Materials
Industry	Metals and Mining
Last Guidance	Jan-19-2015
Next earnings date	4/2/2015

Market Data

Enterprise value	$1,583.37
Market Capitalization	$1,733.33
Daily volume	0.19
Shares outstanding	85.13
Diluted shares outstanding	85.13
% shares held by institutions	54.39%
% shares held by insiders	1.38%
Short interest	0.00%
Days to cover short interest	0.00
52 week high	$17.42
52-week low	$10.38
5y Beta	0.92
6-month volatility	29.60%

Peers	Market Cap.
BHP Billiton Limited	$173,213.58
Rio Tinto plc	$58,806.25

Current Capital Structure

Total debt/market cap	2.90%
Cost of Borrowing	6.95%
Interest Coverage	8154.43%
Altman Z	2.15
Debt Rating	BB
Levered Beta	1.02
WACC (based on market value weights)	8.19%

Management

Professional	Title	Comp. FY2012	Comp. FY2013	Comp. FY2014
Gannicott, Robert	Chairman, Chief Executive Offic	$ 4,309,294.00	$ 3,888,847.00	$ 4,679,442.00
Bell, Brendan	Acting Chief Executive, Executiv	$ -	$ -	$ 1,159,747.00
Pounds, James	Executive Vice President of Buyi	$ 1,492,379.00	$ 1,673,610.00	$ 1,708,784.00
Lavoie, Chantal	President of Dominion Diamon	$ -	$ -	$ 1,399,494.00
Cameron, Ron	Chief Financial Officer	$ -	$ -	$ -
Chetwode, Richard	Vice President of Corporate Dev	$ -	$ -	$ -

Historical Performance

	DDC	Peers	Industry	All U.S. firms
Growth	5.1%	11.6%	2.8%	6.0%
Retention Ratio	123.0%	43.9%	19.3%	61.6%
ROIC		45.7%	77.7%	11.8%
EBITA Margin	22.0%	33.0%	11.1%	13.7%
Revenues/Invested capital	56.5%	65.9%	79.2%	202.3%
Excess Cash/Revenue	26.9%	12.0%	16.3%	18.5%
Unlevered Beta	1.74	0.84		0.95
TEV/REV	3.4x	2.9x	2.0x	2.4x
TEV/EBITDA	10.2x	7.2x	14.9x	11.3x
TEV/EBITA	16.7x	8.7x		15.4x
TEV/UFCF	11.7x	13.6x		26.8x

Past Earning Surprises

	Revenue	EBITDA	Norm. EPS
Last Quarter	-2.3%	56.9%	42.9%
Last Quarter-1	9.3%	15.2%	55.0%
Last Quarter -2	6.5%	43.6%	112.5%
Last Quarter -3	-10.5%	-12.1%	-73.7%
Last Quarter -4	-21.3%	31.7%	

Non GAAP Adjustments

Operating Leases Capitalization	100%	Straightline	10 years
R&D Exp. Capitalization	0%	N/A	N/A
Expl./Drilling Exp. Capitalization	0%	N/A	N/A
SG&A Capitalization	0%	N/A	N/A

Proforma Assumptions / **Forecasted Profitability**

		Period	Rev. Growth	Adj. Op. Cost/Rev	Revenue	NOPLAT	Invested capital	UFCF
Operating. Cash/Cash	25.0%	LTM	50%	61%	$908.34	$110.41	$1,328.56	$113.72
Unlevered Beta	1.00	LTM+1Y	19%	79%	$1,082.93	$31.82	$1,442.11	-$16.57
Rev/Invested Capital	100.0%	LTM+2Y	17%	79%	$1,269.42	$41.13	$1,498.74	-$15.50
Continuing Period Revenue Growth	8.0%	LTM+3Y	16%	79%	$1,475.34	$51.87	$1,569.34	-$18.73
Long Term ROIC	12.0%	LTM+4Y	15%	79%	$1,699.93	$63.97	$1,649.02	-$15.70
Invested Capital Growth	Equals to Maintenance	LTM+5Y	14%	79%	$1,941.74	$77.13	$1,740.66	-$14.51
Justified TEV/REV	2.0x	LTM+6Y	13%	79%	$2,198.56	$91.29	$1,838.58	-$6.62
Justified TEV/EBITDA	12.0x	LTM+7Y	12%	79%	$2,467.40	$106.07	$1,941.84	$2.81
Justified TEV/EBITA	16.0x	LTM+8Y	11%	79%	$2,744.47	$121.13	$2,048.68	$14.29
Justified TEV/UFCF	25.0x	LTM+9Y	10%	75%	$3,025.25	$207.82	$2,160.09	$96.41

Valuation

	ROIC	WACC	EVA	Enterprise Value	Total Debt	Other claims	Equity	Adjusted Price
LTM	8.3%	8.2%	-$66.82	$1,598.42	$45.89	-$72.33	$1,624.86	$19.04
LTM+1Y	2.3%	8.3%	-$87.38	$1,731.33	$45.89	$74.16	$1,611.28	$19.47
LTM+2Y	2.8%	8.4%	-$83.64	$1,895.65	$45.89	$99.59	$1,750.17	$21.09
LTM+3Y	3.5%	8.5%	-$79.61	$2,074.45	$45.89	$127.84	$1,900.73	$22.94
LTM+4Y	4.1%	8.6%	-$75.00	$2,274.10	$45.89	$153.41	$2,074.80	$25.04
LTM+5Y	4.7%	8.6%	-$70.31	$2,489.57	$56.25	$168.27	$2,265.06	$27.44
LTM+6Y	5.2%	8.7%	-$65.62	$2,724.83	$70.75	$172.49	$2,481.59	$29.98
LTM+7Y	5.8%	8.8%	-$61.14	$2,974.59	$80.43	$173.65	$2,720.51	$32.87
LTM+8Y	6.2%	8.9%	-$56.89	$3,238.82	$82.43	$172.45	$2,983.94	$36.29
LTM+9Y	10.1%	9.0%	$22.27	$3,515.25	$82.43	$91.13	$3,341.68	$39.25

Monte Carlo Simulation Assumptions

	Base	Stdev	Min	Max	Distribution
Revenue Variation	0	10%	N/A	N/A	Normal
Op. Costs Variation	0	10%	N/A	N/A	Normal
Market Risk Premium	6%	N/A	5%	7%	Triangular
Long term Growth	8%	N/A	3%	12%	Triangular
Terminal Value	0	0.1	N/A	N/A	Normal

Monte Carlo Simulation Results

	Intrinsic Value	1y-Target
Mean est.	$19.04	$19.47
σ(ε)	$0.32	$0.25
3 σ(ε) adjusted price	$18.08	$18.72
Current Price	$16.40	
Analysts' median est.		$19.49