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Inside this seductive French townhouse on Manhattan's Fifth Avenue, Harry Winston Inc. has built a business convincing very rich men to spend hundreds of thousands of dollars, and often more, to satisfy the desires of their wives and mistresses. The men know - or they will soon find out - that just about any woman will feel sexy when she slips on a few million dollars of diamond jewellery. It's like sliding behind the wheel of an Alfa Romeo. "It changes them, makes them feel special," James Haag, the firm's marketing director, tells me as he unlocks an antique case lined with red velvet and pink petals of faux flowers. "It's not just how they look," he says, "but how they feel."

Haag reaches into the case and carefully draws out a spectacular pair of pear-shaped diamond earrings, 53 carats of flawless gems. He snaps them on to my ears, and something in my brain switches off. I toy with my hair and imagine the looks I'd get from men - and women - if I could walk out of the store right now. Fabulous stars have worn Winston, stars like Marilyn Monroe, who sang "Talk to me Harry Winston," in the movie version of Gentlemen Prefer Blondes. Some women, Haag says, spend years quietly campaigning to bring their men into this hyacinth-scented salon to experience the glamour. And the men, at least those who can afford jewellery that, until recently, cost an average $100,000, usually say the same thing, Haag says: "I'll buy it, if you'll wear it."

The gems, as it turns out, are not the only things for sale at Harry Winston, which has six salons worldwide. It's early spring in Manhattan, and the "jeweller to the stars" itself is on the block, a 51% share. A representative from the prospective buyer is sitting quietly in a plain office upstairs, checking over the fourth draft of a press release announcing a pending "strategic acquisition." One might expect the purchaser to be a luxury brand expert, one who understands what drives men, and women, to spend large sums of money on very tiny things, like diamonds. The pros in this business are lined up along both sides of Fifth Avenue. Tiffany & Co., LVMH Moet Hennessy Louis Vuitton, Cartier and Van Cleef, both owned by Compagnie Financière Richemont are all within easy shopping distance.

But the suitor is not the jeweller next door. It's a Canadian firm, Aber Diamond Corp., which struck it rich about 6,000 kilometres northwest of here beneath an Arctic lake in the Northwest Territories. There, a decade ago, it discovered one of the richest diamond mines in the world, a massive project now known as Diavik, which began churning out diamonds in 2002. For Aber, the money is finally rolling in - and lots of it. This year, Diavik will produce more than six million carats of diamonds, some 8% of the world's supply by value. The mine will last for 20 years. Aber owns a 40% share of the property, a share that will yield projected revenues this year of approximately US$250 million. When production peaks, its profits are expected to hit more than US$100 million per year.

But Aber is not content to be just a rich kid who digs glittering rocks out of the ground. It's going through a total corporate makeover, from the wildly successful prospector it was 10 years ago to the diamond-marketing company it has become today. With the acquistion of Harry Winston, Aber has expanded from simply selling Diavik rough diamonds to running an exclusive chain of luxury jewellery shops. It hopes to achieve two goals with the purchase. First, it wants to seize the tantalizing profits in luxury retail. Second, it hopes that by buying Harry Winston it will complete its transformation, changing its image from that of a miner to that of diamond marketer in both rough goods and luxury jewellery, a move that it hopes will lead to share price gains.

This transformation, of course, is a risky proposition. Studies by consultants and academics consistently show that a majority of mergers and acquisitions do not enhance shareholder value. They erode it. And Aber, which lacks experience in the business it's proposing to buy, is adding to that risk. The management skills required of a prospector and a luxury retailer are drastically different. Diamond prospecting requires the luck, perseverance and the sharp analysis of geological data. Luxury retail ebbs and flows with the stock market, the vagaries of glamour and the consumer-stifling influence of the latest threat of terror attack. So why do it? Maybe Aber is like a rich guy sitting on a load of cash in search of things to do. Maybe it is mesmerized by the Winston magic, as I was when Haag slipped those diamonds on my ears. Then again, this could be a bold move by a successful diamond maverick that will beat the odds and reward its shareholders.

In March, four months after announcing his intent to buy a controlling share of Harry Winston, Aber CEO Bob Gannicott met me at the company's headquarters in Toronto. This is where Aber sorts and values the diamonds pouring in from Diavik, and the style is strictly Bond, James Bond, with glittery black floors and angular black-and-grey furniture.

Gannicott, by contrast, is a down-to-earth geologist and a fan of the arts, who's donated Aber money to the Canadian Opera Company and the National Ballet of Canada. But he's not here to talk about that. Instead, Gannicott shows me the prime display in the office lobby - a cylindrical piece of kimberlite studded with a two-carat diamond. Geologists from Aber and Rio Tinto plc, the U.K.-headquartered mining house that owns the other 60% of Diavik and manages the mine's operations, discovered the gem 10 years ago. It was a stunning find - diamonds are almost never visible in samples like this - and it was the first clear sign that Aber had staked a world-class deposit. The company was going to be rich, and the investors who had been with it from the start were going to be rich, too. (Aber's stock on the TSX is today is valued around $42, up from $1 in 1992. Gannicott's 800,000 shares were worth, at the end of March, about $33 million.)

A junior mining company that hits this kind of motherlode usually takes the money and runs, often back to the bush to scrape for more diamonds. They are driven by the hunt more than the kill. But Gannicott, now in his 50s, wasn't buying another ticket for that lottery. He knew the chances of finding another Diavik were remote. And if Aber returned to the field, it would be up against other companies, including giants like De Beers. Exploration was slow, expensive and incredibly risky. His conclusion: "It ain't the most attractive place to be."

As the Diavik project moved towards production through the late 1990s, Gannicott decided Aber would focus on marketing rough diamonds itself, taking its share of Diavik production in gems rather than money. Although De Beers, the world's most powerful diamond company, still controlled more than 60% of the rough market, it was no longer the monopolist it had once been. There was room for a newcomer like Aber, but turning a junior explorer into a rough marketer wouldn't be easy. For a start, Gannicott would have to keep Aber's share in Diavik. That meant paying for 40% of the mine's constructuction costs, estimated a $1.3 billion. The cost to Aber: $520 million, money the firm would have to find, even though it had no revenues to speak of. In 1998, Aber issued $103 million worth of common shares to raise funds. It later sold a minority holding in another northern find at Snap Lake to De Beers for $173 million. Then Aber concluded a surprising deal. In 1999, it sold Tiffany & Co. eight million of its 57.5 million common shares for $104 million. In addition, Aber agreed to sell $50 million worth of top-quality diamonds to the luxury retailer each year for 10 years, after mine production started. The deal was pivotal. It proved that Aber could market diamonds and generate income. It also gave Gannicott the leverage he needed to secure the last chunk of financing - a US$230-million loan from a syndicate of banks - which was finalized in 2002. "You've got to give the guy credit," says Jim Perrone, an analyst at MacDougall, MacDougall, McTier. "He has a track record of doing very, very smart things."

Having succeeded in finding a business beyond exploration, Aber's management began looking for opportunities further afield. Distributing roughs was something, but it was not enough. "We just collect sacks of diamonds [from Diavik]," Gannicott says. And if that's all Aber did, "there's not much reason for being." An enviable dilemma, one might say. "But you've got to do something," notes Charles Wyndham, a former De Beers marketing executive and partner in the London-based WWW International Diamond Consultants Ltd. "I suppose they could all sit in a tiny office with no cost and just distribute the profits and then close the company when the mine closes, but I don't think many managements would be particularly enthralled by doing that."

Looking along the diamond industry's value chain, Gannicott noted that most of the money was to be made in two places: the mine and the jewellery showroom. A high-quality, three-carat rough diamond from Diavik, for example, can sell for US$9,000. When cut and polished, it will probably produce two diamonds that could be set in rings and placed under the glass counter at Tiffany's. Those rings would sell for more than US$22,000. Playing middleman in the high-cost, low-margin world of cutting and polishing gems didn't look profitable. So, Gannicott figured Aber would leapfrog downstream to retail. Maybe it would even make the company more attractive to investors, he thought. Diamond miners generally earn more than luxury goods companies, yet their shares are cheaper. (Aber's price-earnings ratio in late March was 14.69%, while Tiffany's was 20.35%.) That is, of course, because a mine "is a wasting asset," Gannicott says. "With every shovel full, it gradually depletes." A retailer, on the other hand, can generate a growing stream of revenues. If Aber bought one, Gannicott hoped investors might even see the company in a new light - as a retailer, not a miner - and price its shares accordingly.

And Gannicott had lots of jewellers to approach in a highly fractured market. Local jewellers are king in the global jewellery market, which is estimated at US$65 billion. Even the top five brands - Cartier, Tiffany, Bulgari, Van Cleef & Arpels and Boucheron - together have only 4% of the total market share. But Gannicott believed that a couple of trends were about to change that picture. For one thing, in the U.S., Wal-Mart and the big-volume retail players are now scooping up at least one-quarter of jewellery and watch sales. For another, De Beers has started promoting branded jewellery for higher-end customers. Even though most jewellery customers didn't seem to care about branding, Gannicott was ready to bet that they soon would. It had already happened in other luxury good categories.

And so, Gannicott hired Raymond Simpson, a former De Beers executive, to be Aber's vice-president of corporate development, and set out to buy the best name he could find.

Back on Fifth Avenue, Ron Winston leads me into a tiny private elevator, which lifts us up to his comfortable office, filled with glamorous pictures and memorabilia. Glamour and fame, he remarks, are the most important drivers of his firm's success, and he sure lives the life. On a small table, I note a picture of a younger Ron Winston, in a white suit in Antibes, shot by the late fashion photographer Helmut Newton. And there's a photo of Ron with Mike Tyson, a diamond necklace gleaming on the boxer's gigantic bare chest. (Tyson ripped off a net T-shirt to put on the diamond necklace, and promised to wear it to a funeral.) Another picture shows Ron sitting in the White House with Nancy Reagan. "She borrowed a lot of jewellery," he says.

But while Harry Winston remains a pre-eminent brand, it is not quite as lustrous as it used to be. For 60 years of Oscar nights, it has decked out the greatest stars in Hollywood. Today, it has to fight harder for their attention at the Superbowl of glamour. In 1999, every best-actress nominee wore Harry Winston on Oscar night. The firm's hottest Academy Award story this year concerned the firm's PR director who dropped a US$400,000 diamond and sapphire earring down an elevator shaft. It was recovered, intact, and the story was slipped to a Hollywood columnist as an exclusive.
But the real scoop on Harry Winston, and the reason it was put up for sale, stems from a feud between Ron and Bruce Winston, the sons of the firm's namesake founder, who died in 1978. Throughout the 1990s the brothers fought in court, as Bruce alleged that his Harvard-educated brother, the CEO of the firm, had mismanaged the family asset and dipped into company funds to pay for, among other things, an attempt to be an Olympic sprinter at age 47.

According to New York magazine, which chronicled the affair, court-appointed appraisers suggested that Winston's value declined to US$50 million in 1999 from US$150 million at the time of Harry's death. "My brother made a hash of it," says Ron. "It affected our ability to do business." The legal battle ended, and Bruce sold his share of the business to the private equity firm Fenway Partners Inc. in late 2000, although he and Ron still own the shop on Fifth Avenue.

Ron settles back in his comfortable green chair as he discusses the business's subsequent fortunes. He won't discuss profits, but allows that Harry Winston has US$100 million in revenue from its six salons and 50% gross margins on its Fifth Avenue store. But that's before paying for rent, marketing and advertising, not to mention inventory, which must be pricey when it can take four years to sell an important piece. I ask him why the business is up for sale, and Winston sighs. "It's a long story," he says, adding that the decision was triggered by Fenway. After buying Bruce's share in 2000, the firm wanted to cash out. The usual suspects, including Tiffany, checked out the merchandise a couple of years ago, but all passed. It was a bad time for jewellery. The stock market was depressed, and after 9/11, a lot of rich people stopped travelling. "Luxury companies pursued us," Ron says. "All saw dark clouds on the horizon, so it didn't go very far." Then, in July 2002, Aber came calling. "I was intrigued," Ron says. "Aber came into the void at an auspicious time."

The timing may have been ripe for both Aber and Harry Winston, but that in itself is no guarantee of success. Business history is littered with value-destroying acquisitions by CEOs of companies they know nothing about.

For Gannicott and Aber, luxury jewellery retail - managing real estate and inventory, serving customers and massaging a brand - is outside the experience of a diamond prospector and distributor. In his latest book, Beyond the Core, Chris Zook, a strategy expert with the consulting firm Bain & Co., contends that acquisitions like this one - where a business enters a world with different customers, competitors, cost structure and capabilities - enhance shareholder value less than 10% of the time. The buyer typically pays too much and can't deliver either the operating improvements or the synergies that make the target more valuable and justify the purchase price. Aber could create synergies if it set up a secure supply pipeline between Diavik and Harry Winston. But this is not an exercise in vertical integration. Aber will continue selling to Tiffany and independent dealers; Harry Winston won't be a sure-fire customer for Diavik production and will continue to buy diamonds from its own sources. They will be "separate businesses," Gannicott says, although they will benefit by sharing information on prices of rough and polished diamonds, an advantage that Gannicott refrers to as the "ultimate price-discovery process."

Martin Rapaport, a diamond industry expert and publisher of Rapaport's Report, an industry bible, says he finds it strange that Gannicott is reluctant to integrate vertically. Harry Winston would be more valuable with a secure access to Aber's top diamonds because it would be able to mark-ups from middle men in the trade. "If there's no direct access, he might as well invest in McDonald's."

But Gannicott has admirers, too, like Chaim Even-Zohar, a Tel-Aviv-based industry consultant and author of From Mine to Mistress, a $500 tome on the diamond business. Even without a vertical integration play, which may eventually happen, the deal "makes a helluva lot of sense," he says. "By becoming a luxury goods company, he'll make a helluva lot more money for shareholders." WWW International's Wyndham says he also thinks it's logical to leverage a good position selling roughs into something that offers a longer life than a 20-year mine. It's certainly less risky than exploration, he notes. And besides, Aber can afford it.

On April 2, Aber announced that it had closed its deal for Harry Winston Inc., and bought 51% of the company for US$85 million. Fenway Partners and Ron Winston will remain minority shareholders, with 30% and 19% of the company respectively. Ron will stay on as chairman, although he will no longer be running the show.

The press release announcing the close, however, offered few details of what the company will look like going forward. It said Aber had picked an experienced retail management team to run the business, but that it wouldn't announce the appointments for a few weeks. When the management comes in, however, it will start work on opening two new stores, in Las Vegas and

Taiwan, bringing the number of Harry Winston salons to eight from the current six. (Harry Winston has stores on Fifth Avenue and Rodeo Drive, and in Paris, Geneva, Tokyo and Osaka.) It will also oversee Winston's move into less expensives jewellery to open new markets among the not-quite-so-rich.

So, Aber will be what Gannicott hoped - a diamond company that distributes rough diamonds and sells diamond jewellery. Before the deal closed, Gannicott said he's buying a majority stake in Harry Winston because he thinks luxury retail is the most profitable part of the diamond business, other than mining. He hopes Harry Winston will be even more profitable once Aber's cash fuels its expansion into different stores, and less expensive products. If it works, Gannicott hopes the riches pouring out of Diavik won't just last 20 years, the life of the mine, but perhaps forever.

But if business history is any guide, this is a long shot. Making the leap from mining and distribution to retail is risky business. Over a year ago, De Beers, the former diamond monopolist, and LVMH, the master of luxury brands, set up jewellery stores in London and Japan, with an investment of US$200 million from each partner. It's supposed to be a branding exercise - like Nike stores - as part of De Beer's campaign to focus on promoting demand through more marketing and advertising rather than by controlling supply. Yet as a retail operation, the De Beers LV stores have had a tough time. Sales have been disappointing; expansion into the U.S. has been delayed.

De Beers's troubles don't deter Gannicott. Buying Harry Winston is a key part of his corporate makeover from hard-edged prospector to luxury retailer. To complete the job, he may even change Aber's name to Harry Winston, according to Even-Zohar. So, Aber would become, in name at least, the "jeweller to the stars." Maybe, Gannicott hopes, investors will see the company in a whole new light.