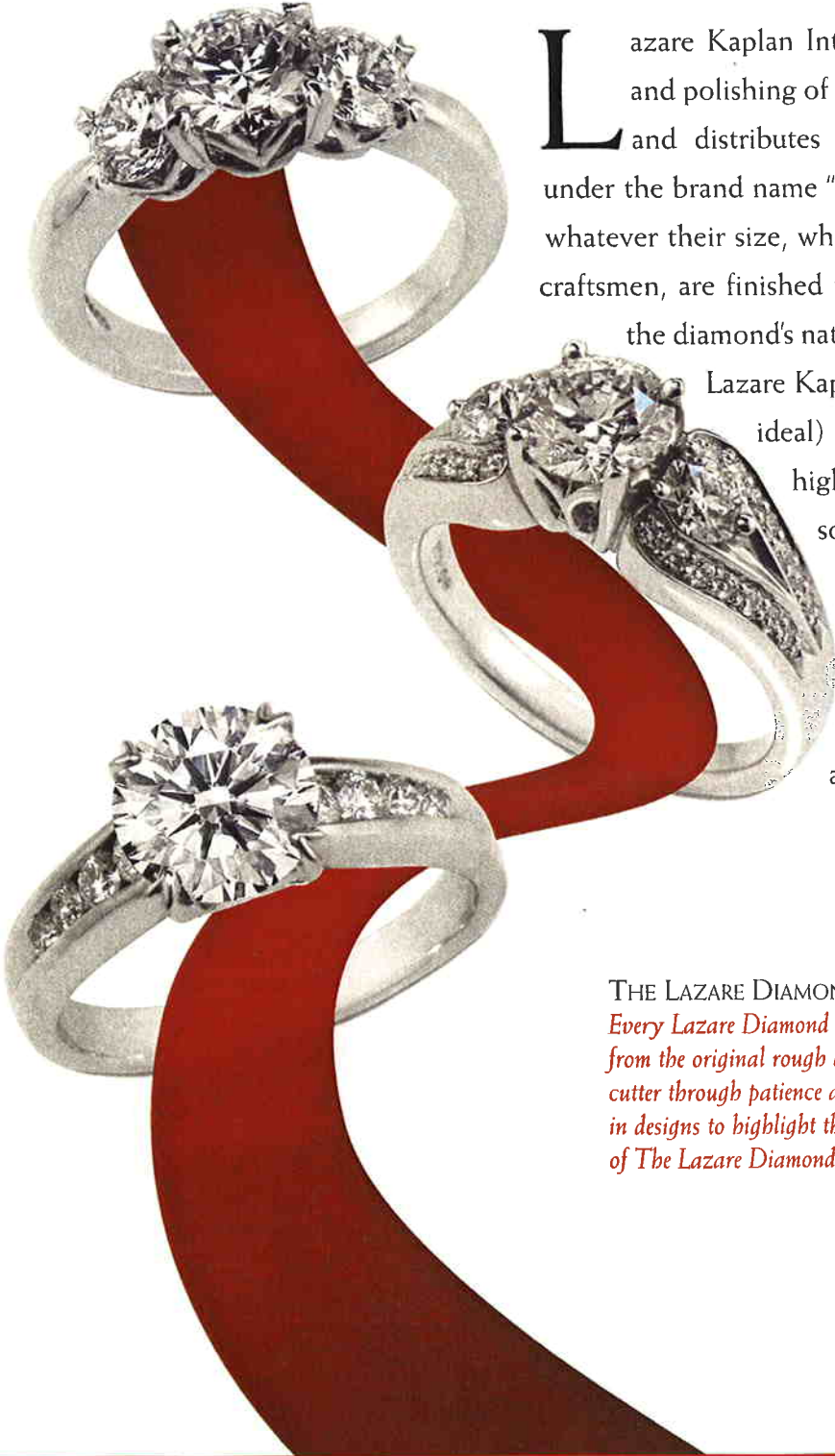




LAZARE KAPLAN INTERNATIONAL INC.

2006 ANNUAL REPORT

the world's most beautiful diamond



Lazare Kaplan International Inc. is engaged in the cutting and polishing of ideal cut diamonds, which it laser inscribes and distributes to quality retail jewelers internationally under the brand name "The Lazare Diamond®." Lazare Diamonds, whatever their size, which are cut and polished by Lazare Kaplan craftsmen, are finished to precise proportions, bringing out all of the diamond's natural brilliance, sparkle and fire. In addition,

Lazare Kaplan also cuts and polishes fine make (non-ideal) commercial diamonds and high pressure, high temperature (HPHT) processed diamonds sold under the Bellataire® diamonds brand name. These stones are sold through wholesalers and distributors and, to a growing extent, through retail jewelers. Lazare Kaplan is also engaged in the buying and selling of uncut rough diamonds.

THE LAZARE DIAMOND®

Every Lazare Diamond has been transformed from the original rough diamond by a master cutter through patience and precision then set in designs to highlight the exceptional quality of The Lazare Diamond.

To Our Shareholders:

The Company's revenue in fiscal year 2006 was \$528,045,000 compared to \$421,411,000 in fiscal 2005. Net profit was \$1,528,000 in fiscal year 2006 compared to \$5,230,000 in fiscal 2005.

2006 was a challenging year for the Company as well as for the industry as a whole. The changes in the macroeconomic environment, brought about by the decision of the Federal Reserve Bank and other Central Bankers to gradually shift from a stimulative accommodating monetary policy and low interest rates to a more restrictive posture draining liquidity and raising interest rates, had its impact on discretionary spending by consumers, dampening their spending patterns and their willingness to incur further debt. This resulted in more conservative buying and restocking by our jeweler customers, as well as industry-wide liquidity issues that require careful and prudent attention from the Company's management.

In last year's letter to shareholders, we pointed out that while the structural transformation of the diamond industry from its historic supply-driven anchor to an increasingly demand-driven business—including the elimination of the buffer stock regulator and the consequent increase in price volatility—was progressing well—in fact, better than expected—the new dispensation taking its place had yet to be tested by a cyclical downturn and its consequences. While the downturn the industry is now feeling was not entirely unexpected, as it is part and parcel of the normal business cycle, it is putting structural strains as well as cyclical strains on the industry. Pressures previously masked by the benign macroeconomic environment of the last several years that is coming to an end are now becoming apparent. So far these structural strains primarily have manifested themselves in the downstream manufacturing and distribution segments of the pipeline. For some time now, these segments have suffered from inadequate operating margins and excessive leverage. While this reality is painful to the

companies operating in those segments, a dysfunctional pipeline will in time affect the other segments of the business. Although the structural issues are more fundamental in nature the immediate triggering events were a series of unjustified and excessive price increases by rough diamond producers driven by cyclical euphoria that could not be translated into higher prices for polished diamonds and an exceptionally accommodating lending policy by banks financing the industry pipeline. As the present situation is unsustainable it is bound to self-correct or require important structural industry-wide adjustments. All the industry's stakeholders, i.e., producing countries, mining companies, and banking institutions that finance the pipeline as well as the manufacturing segments have a vital stake in how and over what period of time the corrective measures play out. The Company views these challenging times as a welcome opportunity to recalibrate industry structures and business plans to better deal with future opportunities. In summary, the Company is navigating with care and prudence through the shoals exposed by this cyclical downturn, while it vigorously pursues and builds on upstream and downstream opportunities aligned with our vision of how the industry restructuring will eventually evolve.

The Company continues to receive high marks as a Diamond Trading Company (DTC) sightholder. As the measurement criteria are aligned with the Company's historic commitment to global downstream marketing, branding, quality service, strong balance sheet, best practices and transparency, the Company continues to receive a high ranking under the DTC's Supplier of Choice (SOC) program. The Company expects that the SOC program will have to be recalibrated to reflect the industry-wide structural strains, including the changing relationships between the major producing countries of Botswana, Namibia and South Africa with the London based DTC, to reflect the more vigorous implementation by these producing countries of their



*The ideal statement starts
with the ideal diamond.
The Lazare Diamond®
is the original ideal cut
diamond since 1919.*

Since 1903 the Company remains dedicated to cutting the world's most beautiful diamond and continues to maintain the highest standards in the diamond industry.

policies on local beneficiation and employment, as well as their desire for greater input on how these depleting natural resources are developed and on the benefits that these countries derive from them. The Company is well positioned in these countries to participate in and to contribute constructively to the evolution of these developments.

The Government of Botswana has granted the Company one of several licenses it recently issued for setting up cutting and polishing factories in that country. The issuance of the license was based on a viable multi-year business plan submitted to and approved by the Government. The Company is in the process of setting up local management—it has selected retired Ambassador Alfred Dube as its Managing Director,—acquiring suitable land in the capital city of Gaborone and drawing up the plans for construction of a state-of-the-art facility. The Company is aligning the implementation of its investment, manufacturing and marketing policies with the publicly stated objectives of Botswana,—the world largest and lowest cost rough diamond producer—to enhance local beneficiation and, in time, to become the center of gravity for the diamond industry.

Good progress continues to be made in implementing the Company's Cooperation Agreement with NamGem—Namibia's flagship cutting and polishing plant. The transfer of technical and marketing skills is proceeding apace, and the trained professional workforce under the effective leadership of a well-qualified Namibian Managing Director, Eliphas Hawala, is successfully polishing increasingly larger sizes of diamonds to LKI's demanding quality standards. In conjunction with the terms of the \$25 million financing facility now in the final stages of negotiations with the U.S.



Government's Overseas Private Investment Corporation (OPIC), the Company is in the process of securing a long-term supply commitment for suitable rough for NamGem. Under the terms of its Cooperation Agreement with NamGem, the Company has the option to acquire an equity holding in NamGem and notice to that effect has been given to the existing shareholders. The Company is also giving serious consideration to an expansion of the existing facility—a decision that is linked to commitment of rough diamond supplies adequate to justify the investment. The Company is contemplating the creation and marketing of high quality Namibian brand diamonds, if and when the sourcing of appropriate rough diamonds makes such a project possible. The Government of Namibia has been, and continues to be, very supportive of the Company's initiatives, as their prompt and successful implementation is closely aligned with the Namibian Government's development and employment policies.

In South Africa, the agreement with Nozala Investments (Pty.), a broadly based women's empowerment investment group, is successfully being implemented under the leadership of its South African Managing Director, Ms. Noluthando Poswa, and with effective technical and marketing support from the Company. Nozala is now regularly cutting and polishing large-size rough diamonds (+10.8 carat and larger) to world-class standards. Nozala is in discussion with the Government of South Africa and with its rough suppliers on expansion of its operation. An apprentice training program is now in place to prepare for this planned expansion.

Following several years of peace, and with the stimulus of higher oil prices, the Angolan economy is now growing at a rapid rate. Much remains to be done, but there are visible

A dazzling array of ideal cut Lazare Diamonds in superb settings. Only the finest jewelry is worthy of holding the finest cut diamond.



signs of economic, social and infrastructure development taking place in Angola. This is a welcome development, and the Company's in-country activities are growing in scope and importance. They are widening from our initial Technical Assistance Contract with Sodiam,—the Angolan Government parastatal legally responsible for marketing Angolan rough diamonds,—calling for staffing and operating of buying stations and marketing of a portion of the diamonds produced in the informal sector, to participation in ventures marketing diamonds produced by the Angolan formal sector and seeking to secure exploration and mining rights for attractive Kimberlitic prospects. In addition to these direct investments in the diamond sector of the economy, the Company is making a substantial investment in Angola's post-war reconstruction efforts. The Company has taken the lead with US AID and F.A.S. (a self-standing, not-for-profit organization funded by the World Bank) in organizing and funding a multi-year social responsibility program in Lunda Norte. The work of this consortium will be managed in a transparent and hands-on manner by a competent N.G.O. familiar with the area, after consultation with the local population and the Angolan authorities. The selected projects will focus on reconstruction and on improving the quality of life of the people in Lunda Norte.

The Company's operations in Russia, under existing long-term agreement with A.K. Alrosa, that country's primary diamond producer, continue to be successfully implemented. With the decision by the Government of the Russian Federation to increase its shareholding in A.K. Alrosa to a majority stake, the termination over the next few years at the behest of the European Competition Authority of the A.K. Alrosa-DeBeers rough diamond marketing agreement, and the pending legislation liberalizing the Russian diamond business, the Company expects to see changes in the way Russia—the world's second largest rough diamond producer—comes to market with its considerable diamond production. At the appropriate time and level the Company expects to review and explore the opportunities that these changes present, taking into account and building on the successful track record the Company has developed with A.K. Alrosa over the last decade.

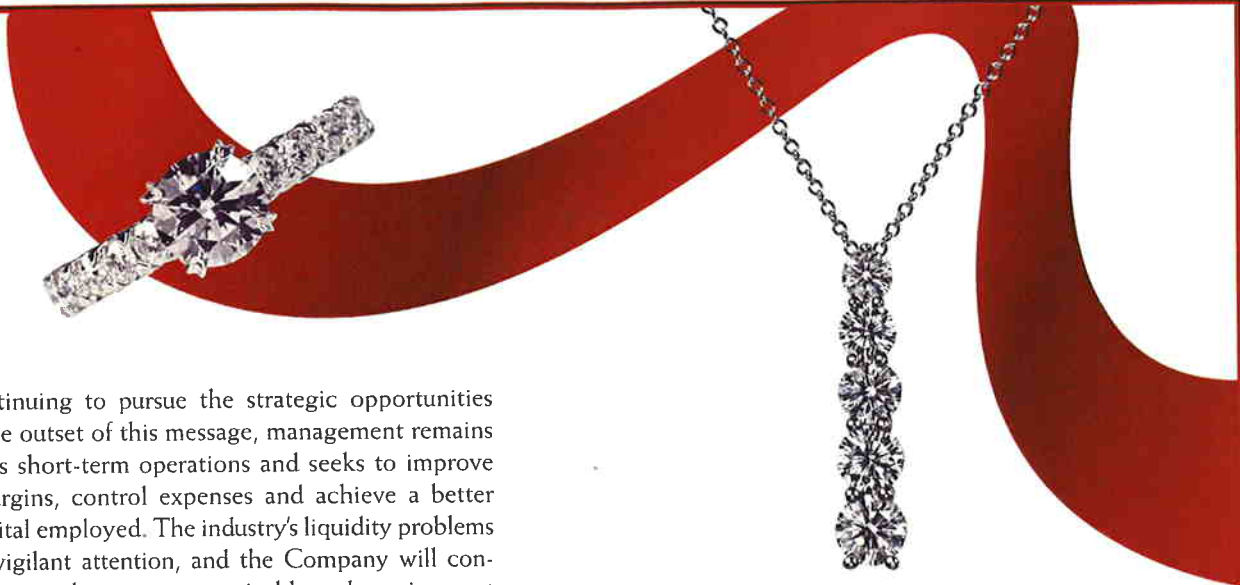
Careful attention to the rich detail and beautiful finish is taken not only with our diamonds but also with each and every piece of jewelry.

The Company expects that several, if not all, of the projects in various stages of implementation will qualify for financing under the Framework Agreement the Company signed with The Overseas Private Investment Corporation (OPIC) for financing diamond beneficiation and mining projects in Angola, Botswana, Namibia, Russia and South Africa.

In order to be in a position to benefit from these developments, the Company continues to enhance and build its rough trading capacity and relationships. As this year's performance indicate rough diamond trading is an increasingly important self-standing profit center, as well as an optimization regulator for the rough diamonds the Company selects for production in its various cutting and polishing operations.

In order to vigorously pursue greater market share for its premium quality product, "The Lazare Diamond®, The world's most beautiful diamond®," as well as the high quality commercial diamonds now part of the Company's broader product offering, the Company continues to strengthen and deploy management resources to focus on a robust hands-on campaign to improve relationships with existing customers by adding value to our offering, to develop and nurture new markets domestically and overseas, and to improve the quality and relevance to our customers of our extensive inventory as well as to improve inventory turns and overall productivity. Although the present downturn presents operating challenges that, in all likelihood will be with us for some time, improvements in many areas of the Company's performance and enhanced productivity are noticeable, and the Company will continue to drive these measures as hard as possible.





While continuing to pursue the strategic opportunities outlined at the outset of this message, management remains focused on its short-term operations and seeks to improve operating margins, control expenses and achieve a better return on capital employed. The industry's liquidity problems also call for vigilant attention, and the Company will continue to manage credit, accounts receivable and consignment exposures with prudent conservatism.

The Company has rationalized and simplified its jewelry offering in the United States and abroad. The Company expects to drive that segment of the business, as well as accelerate the roll-out of LKI boutiques and self-standing stores—an initiative that has shown considerable success, particularly in Southeast Asia.

The Company is implementing its agreement with LJ Superabrasives Holdings Inc. (who in 2004 acquired an interest in Bellataire® operations from General Electric Company). Progress is being made in the management and marketing areas while further work needs to be done to augment the sourcing of suitable material.

Over many years the Company has made many important scientific and technical discoveries, on its own and with others, that have commercial application in different areas of the diamond and diamond-related industries. At a time when national and corporate comparative advantage is increasingly knowledge based, the Company views its patent portfolio as a valuable asset of its shareholders. To protect this asset, the Company recently commenced legal action against Photoscribe Technologies Inc. for what it believes are infringements of the Company's patents for diamond laser inscription. The Company is determined to pursue its case vigorously in the courts and to seek legally enforceable remedies against Photoscribe and others that are infringing on what the Company believes to be its intellectual property.

The Company's manufacturing facility in Puerto Rico, recently refurbished and re-equipped with the latest state-of-the-art technology, continues to take the lead in precision diamond polishing that distinguishes "The Lazare Diamond®, the world's most beautiful diamond®" from other diamonds. The Puerto Rico facility and its skilled professional staff also continue to provide the reservoir of human resources required to implement the expanding number of manufacturing facilities in Russia, Namibia and other diamond producing countries.

In line with the policies of transparency required of publicly listed corporations and the new legislation, regulations and practices applicable to the diamond industry, the Management of the Company spends considerable time and resources on compliance to ensure that best practices are built into the way it does business. An internal review process is in place, reinforced by regular educational seminars, and a full-time compliance officer ensures that everyone employed by the Company is sensitive to these requirements and that they are reflected in how and with whom the Company does business. The Company's activities are in compliance with the Kimberley Process Certification Scheme, the World Diamond Council's System of Warranties and the provisions of the USA Patriot Act. As a founding member of the UN Global Compact, it adheres to the GC's ten governing principles. It is also the Company's policy to encourage its management and employees to participate in social and development activities that benefit broader society in the countries where it operates.

We greatly value the dedication, professionalism and hard work of our employees in the many countries in which we do business. We respect and appreciate all you do and how you do it.

A handwritten signature in black ink, appearing to read "Maurice Tempelsman".

Maurice Tempelsman
Chairman of the Board

A handwritten signature in black ink, appearing to read "Leon Tempelsman".

Leon Tempelsman
Vice Chairman of the Board