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DIAMOND TRADING NETWORK

THE 2019 PIPELINE

Prelude to the Storm

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STUDIO SPECTOR

The 2019-2020 period is evolving as a dramatic game changer for the entire world. This is even more so for the diamond industry where a gradual pipeline restructuring process finally matured into an inevitable and, in fact, a most desirable conclusion for the midstream sector – the manufacturers of the rough and the traders of the polished. Finally, this quite squeezed sector from a profitability aspect, began to act purely in their own economic, financial, and commercial self-interest less burdened by producer pressures to "relieve" them of their stocks.

Led by the massive Indian diamond sector, the manufacturers put four months break on their rough diamond purchases. In 2019 the producers were faced with considerable resistance to purchase their rough allocation which was met, to quote the CEO of De Beers, "with unprecedented flexibility in the way it sold its diamonds to sightholders because of the nature of the market". In February 2020, well before the pandemic struck the world in full force, the heads of both De Beers and Anglo American announced that they would change their allocation system (sights) and that no buyer will be "unaffected" by the changes in the sight system. The Indian industry didn't wait to find out what scheme the producer would introduce.

The Emperor Has No Clothes

The changed behavior goes far beyond just a restructuring of rough supply contracts. **The diamond pipeline has for the first time in almost hundred years become truly demand driven – at each and every level of the pipeline.** It has become a normal competitive industry not any more driven by the rough supply side. De Beers, which already acknowledged it doesn't view itself anymore as custodian (benevolent godfather), had lost something else: **it has ceased to be the rough diamond price setter of the industry.** It has lost the rough diamond placing power it had enjoyed for so long.

In the long term, this is a welcome development. The diamond industry will become structurally not only more competitive, but **also much healthier.** Each pipeline level has become a "price taker" - a market participant that is not able to dictate the prices in a market and must accept the prevailing market price.

Oddly, there are some producers who still are in a state of denial. When producers were shown that clients lost money on their rough purchases, that the midstream was squeezed and profits were minimal or not existing, producers dismissed these laments with "customers take their own financial decisions." Producers for too long justified maintaining high rough prices knowing full well that they were unsustainable. The rough side was driven mostly by greed, skillfully exploiting the fragmented manufacturing sector. This time the Indian sector acted in unison. It's ironic, that the producers' reaction to a prolonged rough diamond buying stop from the top producers was that of anger at the decision, claiming "we are all in the same boat". While trying to push and sell their rough they argued that all pipeline players' decisions should keep the health of the entire pipeline in mind.

While the frustration of the producers is understandable, what is clear is that the entire pipeline has now become more market driven and rough producers would also be subject to the same vagaries of the market. After nearly a century of a controlled pipeline, the midstream has realized that the emperor has no clothes, and the entire pipeline is at the mercy of the market.

Recognizing that this is the situation, the two top producers reacted differently to their own stakeholders, their own workers. De Beers responded by primarily reducing production, while Alrosa seems to have responded by showing a greater emphasis on increasing their stock of rough. It was assisted by the Russian government as the state diamond depository (Gohkran) acquired large stocks. As the market recovers, the Russians, with greater available stocks may try play a bigger part in setting prices, but it will not inherit the mantle of the price setter. There won't be a return to the past. Let us understand how these changes came about.

TACY'S 2019
DIAMOND PIPELINE

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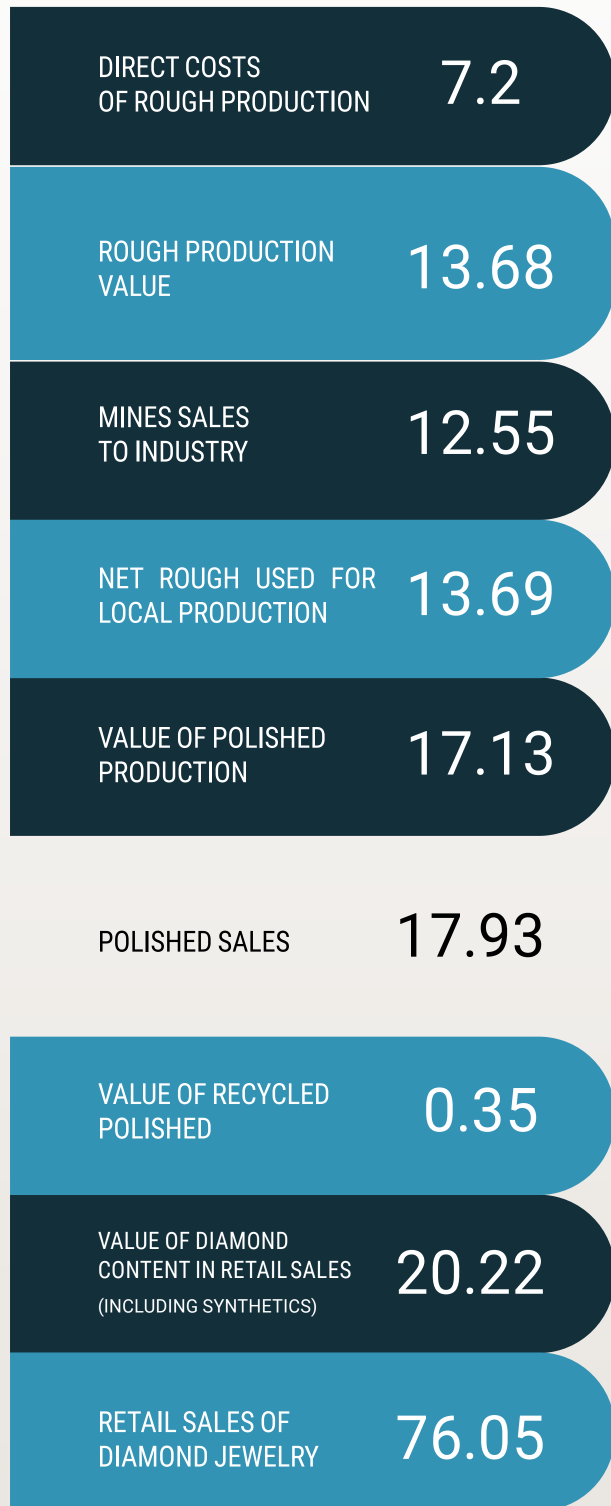

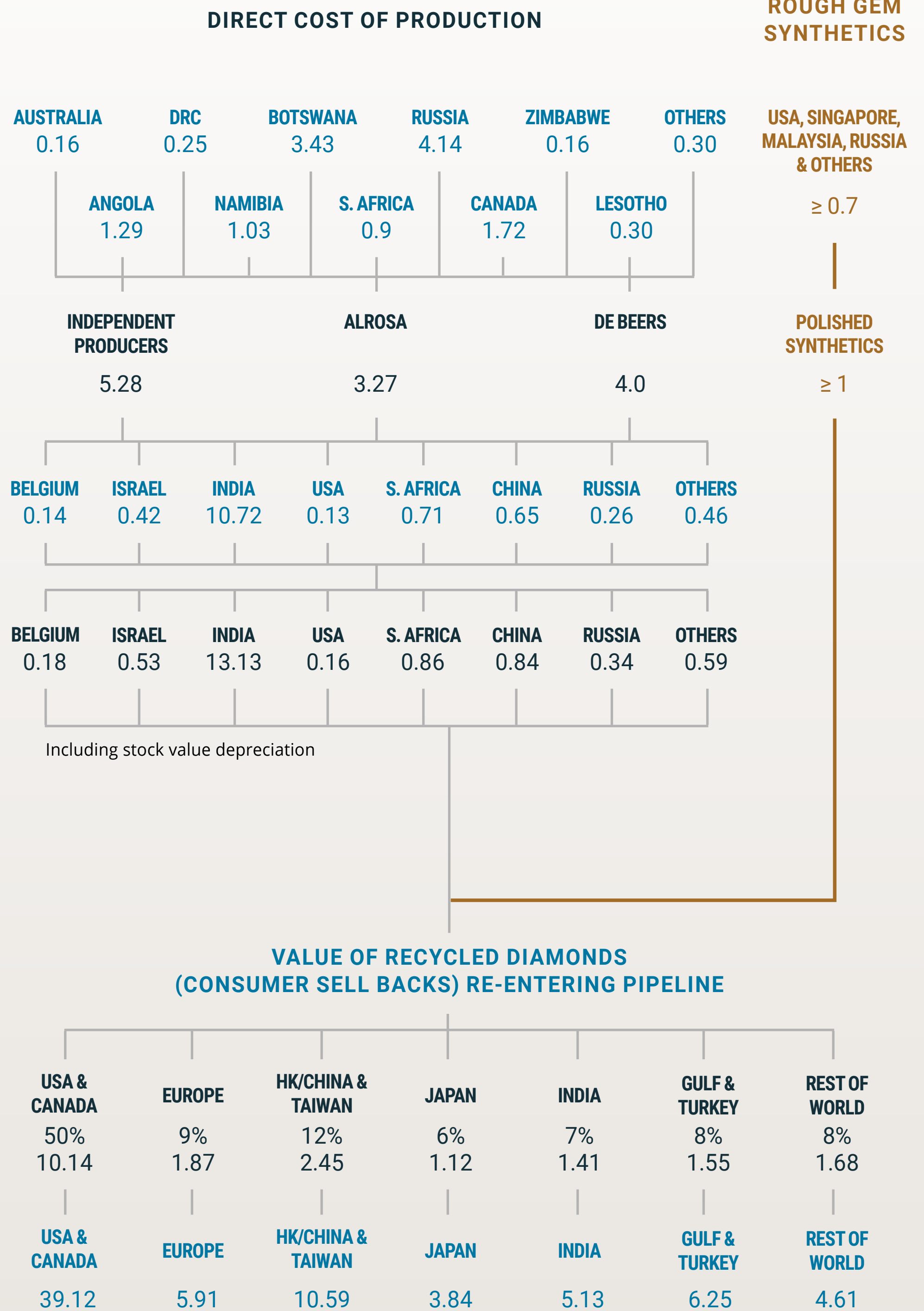

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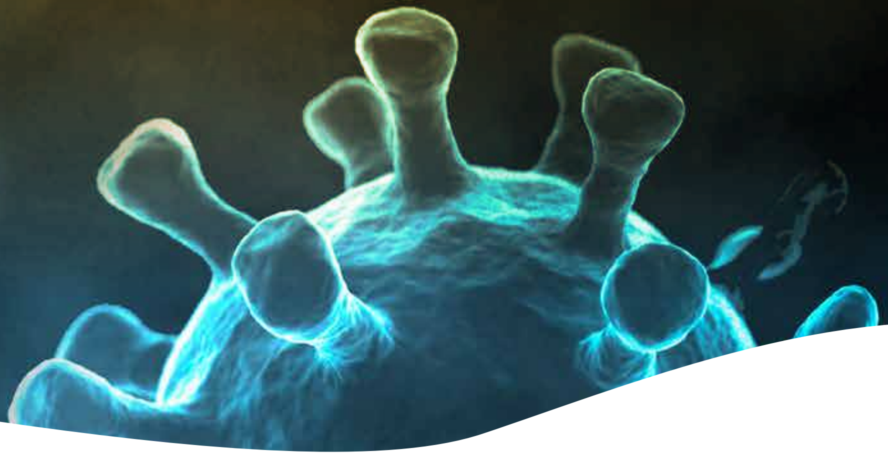


2020 Buoyant Beginning

2020 started out quite positively. The industry had already started buying rough from November, in anticipation, and the first couple of months showed they were on the right track. Both rough purchases and polished sales were on an upwards trajectory.

The world reacted slowly to the Covid-19 crisis. While reports from China appeared in early January, and a lockdown of a province followed later in the month, the world was generally more sanguine about it, expecting it to be a localized problem. Business anxiety started increasing in February, but the full global impact of the crisis didn't become apparent until the middle of March.

Rough and polished sales followed a similar trajectory, with polished peaking in January and the full decline being felt in March, as most centers went into some sort of a lockdown. From November 2019 to March 2020, it is estimated that the industry, as a whole, bought USD 1.5-2.0 billion of excess rough from the producers. The industry was saddled with this at a time when most activity was brought to a sudden standstill.

Business Impact of Covid19

All about Demand

Much has been written about the impact of the Covid-19 crisis and the work-from-home phenomenon. While the authors would leave the reader to draw their own conclusions, we will talk about some of the takeaways affecting the industry and its way forward, which we have extracted from a mountain of research.

The Covid-19 pandemic and the resultant measures taken by governments have had a unique and unforeseen impact – primarily driven by the lockdown measures imposed across the world. All businesses or activities which require employees' physical presence suffer during lockdown, whatever the severity and duration. Those which can operate remotely manage better.

If we take a space station view of the crisis, the global GDP is determined by the sum total of all resources used by us as a species. The greater the consumption of resources per capita, the higher the standard of living. Hence all the wars in history have essentially been fought over the control of resources. Prices, wages, rents or interest determine the internal allocation and share of the resources available to individuals, and will affect the relative gain or loss by individual participants in the economy.

Business restrictions during the lockdown affect the production and extraction of resources, as well as the demand for them. The lack of manpower required to operate the machinery affects the resource collection, while the lack of activity means that the demand for a majority of the resources also drops. Prices, wages, rents and interest are simply the ways in which the demand and supply is matched. Given that capacities for the extraction of most resources are more than adequate, it is the demand which will drive GDP and the eventual recovery.

The fall in demand also has a compounding effect. A prolonged drop in demand means increased business bankruptcies, which in turn would mean further demand destruction due to loss in employment and activity. Governments around the world are aware of this and have launched record-breaking support and stimulus packages.

Stimulus packages are broadly of two kinds.

- The direct stimulus puts food and/or money directly in the hands of the consumers based on set criteria. This can include unemployment benefits, salary support or furlough schemes, free or subsidized food or direct subsidies paid to companies to help them retain their employees or tax reliefs given. This directly impacts demand.
- The second kind of stimulus involves some kind of funding support such as loan deferral or the extension or loans at low rates to help individuals and companies tide over their liquidity crisis created by the need to keep paying bills despite a sudden drop in revenue. This stimulus provides liquidity to businesses, which are hopefully solvent, to get through the crisis. This is to be paid back at a later date, with the government acting as a guarantor of some sort. This does not directly create demand, but helps businesses get back on their feet after the crisis, thereby preventing further knock on effects

The impact on the GDP or countries is clearly visible in the Q2 2020 GDP numbers. The US, launched a support package amounting to nearly 10% of its GDP. Almost half went as a direct stimulus, which resulted in its GDP declining by about -9.5%. India, which had a modest direct stimulus, saw a corresponding decline of nearly -23.9%. Note that a direct stimulus which is say 3% of annual GDP direct stimulus spent in one quarter has an effective impact of nearly 12% on the GDP for that quarter.

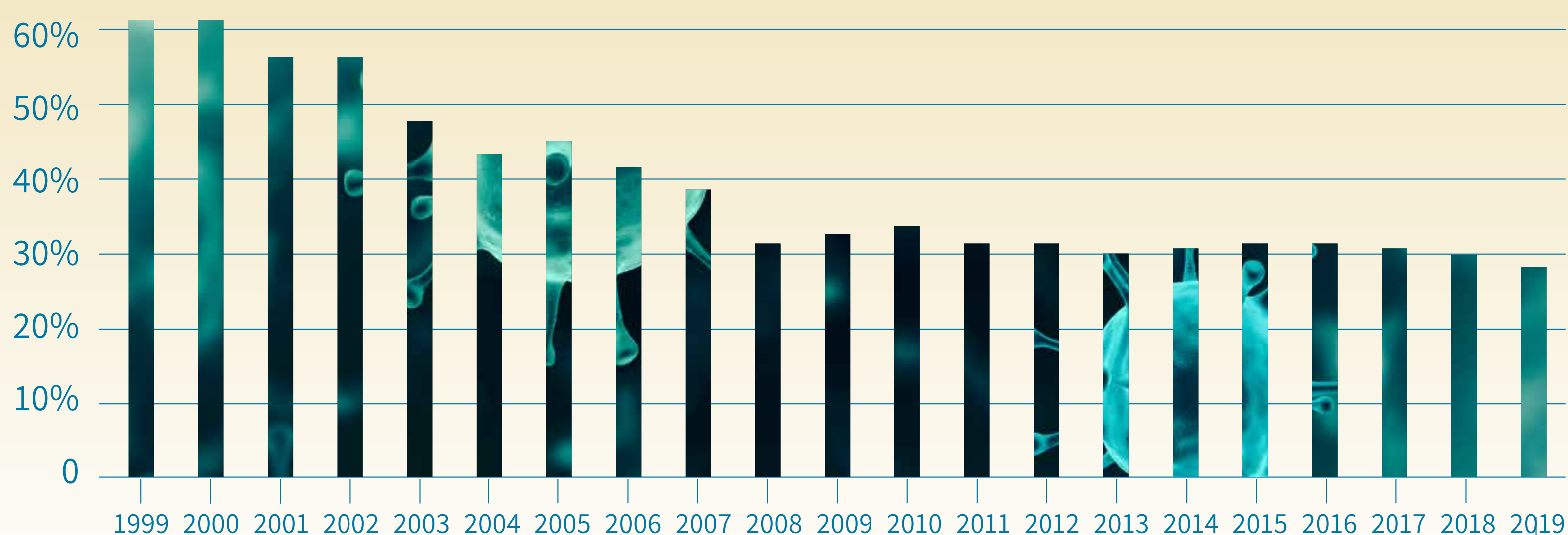
In the longer term, demand challenges will remain. The travel & tourism, hospitality, retail, sports entertainment and a few other sectors are expected to be affected the most due to the social-distancing and the possibility of multiple waves. These sectors are estimated to account for about 25% of the global GDP, if you include the direct, indirect and induced impacts. By most accounts, these sectors will struggle to recover even towards the end of 2021 – implying that the impact on the GDP is expected to last well into next year.

Luxury Spending

Lower but More Focused

The diamond industry competes for attention in the global luxury industry. We have been reporting for years that the share of the diamond retail as compared to the global luxury industry has been declining. It has nearly halved in percentage terms in the last 20 years (see chart on Ratio of Retail Diamond Jewelry Sales to Luxury Industry Size).

Ratio of Retail Diamond Jewelry Sales to Luxury Industry Size



The luxury market was expected to take a significant dip due to Covid-19. A report by Bain & Company, titled "Luxury after Covid-19: Changed for (the) Good?" estimated the market for luxury to drop by 15-35%, with the median case scenario showing a drop of 22-25%. Given that the diamond industry has underperformed the growth in luxury, the scenario for diamonds was not looking particularly exciting for the year.

However, the numbers, especially from the US market which accounts for nearly 50% of the total diamond sales, showed a V-shaped recovery (see chart on V-Shaped Recovery in Jewellery Sales). After dismal sales from March to May, in the following months, jewelry sales trended above the previous year, giving some respite to the retail jewelers which is percolating down into the midstream and eventually into the rough. Rough mining companies had seen little sales for nearly four months, but have now started seeing an uptick in sales. The Mainland Chinese market has a similar profile, with sales getting back to last year levels.

V Shaped Recovery in Jewelry Sales

This surge was attributed this to "revenge spending" but does this mean economies are back on an even keel and our growth problems are behind us? It might not be that simple.

On a global level, a large part of the population has been struggling, with reports of a significant number falling back into poverty. Unorganized businesses have suffered the most. However, there are industries and companies – health and some technologies for example - that have been relatively unscathed in the process. People working in these areas have not seen a significant drop in their incomes, while the avenues for them to spend have drastically reduced due to the lockdowns.

Experiential purchasing was increasingly becoming a larger part of the luxury spending and competing with jewelry for the share of the wallet. People were showing an increasing preference for exotic holidays, spa experiences, luxury dining, premium show tickets etc, compared to buying jewelry. Lockdowns shut down a large number of these spending avenues, as experience requires some contact, which increased the risk of Covid-19. Hence there were many higher earners who found themselves with the same disposable income, but significantly fewer ways to spend it. As the global personal savings rate surged, some of this money seems to have found its way into jewelry purchases.

Considering these factors, the authors still believe that retail polished wholesale price (PWP) demand for diamonds will drop by about 20% this year, doing better than luxury spending in general.

2019 A Blessing in Disguise?

2019 was a year when the industry saw the lowest sales in a decade, but it was supposed to be the pivot for the years ahead. As the industry digested its excess production, it set the stage for a significantly improved performance in 2020. The authors projected in November 2019 that sales for 2020 would be back at 2018 levels for both rough and polished, but that was not to be.

However, 2019 did prove a blessing in disguise for the industry, in a manner of speaking. The belt tightening across the industry meant that inventories were in a much better position as compared to prior years. Also, companies in the midstream had worked on cutting costs throughout 2018 and 2019, leaving them in a far better shape. This holds true of both the retail and polished pipelines, but it did leave the rough producers in a much more vulnerable state, especially companies that had decided to stockpile rough, as it bloated their balance sheets.

2019 A “Gap Year”

The diamond industry was expecting a “gap year” in 2019, a year when stock levels would adjust to ensure the health of the entire pipeline and it indeed it endured a tough year with polished and rough sales hitting their lowest levels in a decade.

It should also have been the pivotal year when supply peaked, prices bottomed out, and the stage could be set for several years of healthy price growth.

The end of 2019 and early 2020 looked promising. The industry started its stocking cycle post the factory reopening in November. The pipeline had been cautious through much of 2019 and had reached acceptable stocking levels by the end of October. With season sales projected to be positive in the US, the market started re-stocking, in anticipation of a bumper 2020.

However, this was not to be. The Covid-19 crisis hit the global economy in early 2020 and things took a turn for the worse. 2019 was no longer a pivotal year, but a prelude to the storm which was to hit the industry in 2020.

RETAIL A Mixed Bag

2019 began on a soft note on the retail side. The 2018 season was slightly below expectations, with the US federal government shutdown and the furloughs during the December 2018 to January 2019 affecting sales. This trend continued through to the middle of 2019 and gradually improved during the latter half of the year, along with the US economy. During the 2019 season, the positive impact, due to the depressed sales in the previous year, meant that the overall sales for the year were positive for the industry.

Diamonds are traded and dealt in US dollars. This means that any strength in the dollar, weakens the sales in the rest of the world, when translated into dollars. The US dollar gained strength in the latter half of 2018 and into 2019. This meant that the retail offtake, in dollar terms, especially in China and Europe were subdued.

Hong Kong and China are the next largest market for diamonds after the US. Hong Kong had its share of unrest, as the protests against the governments took on a life of their own. Hong Kong’s retail sales took a significant beating as it relies heavily on tourist traffic, especially from mainland China.

Sales in mainland China itself were also sluggish. The trade war with the US, which played out through much of 2019, meant that imports from China were taxed and economic activity did not grow at the expected pace. The Yuan depreciation meant that the increase in sales in local currency did not translate into a similar dollar

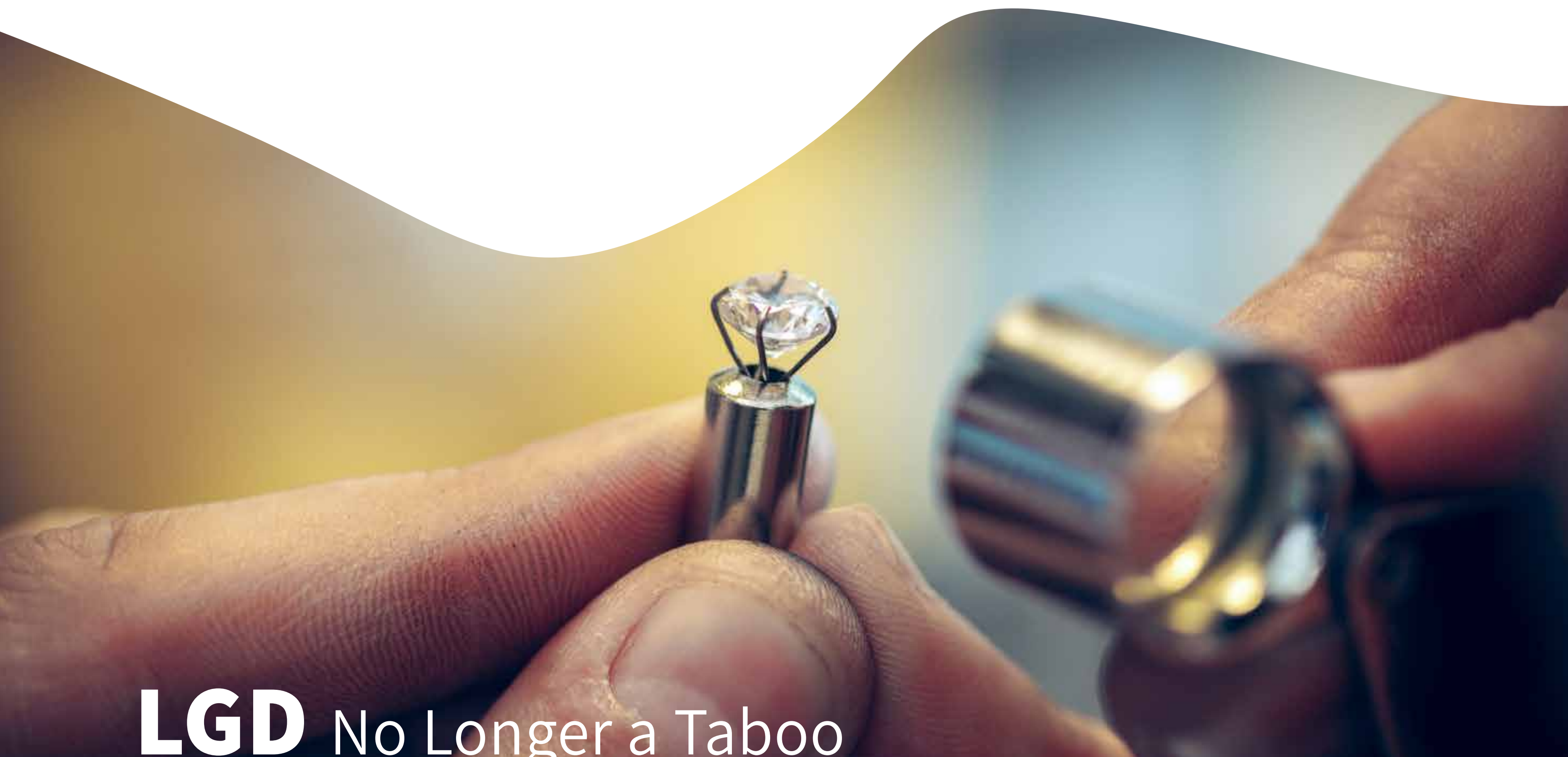
amount. Hence, on an overall level, there was a sizeable drop in sales in the Hong Kong China region, especially when converted to a dollar amount.

India too witnessed its growth momentum slowing. General elections were held in 2019, and while this is generally expected to boost GDP, the other factors including bad bank loans weighed down on the general business sentiment, which flowed into a lackluster demand for diamonds. While there was some growth in local currency terms, this was effectively flattened by the weakening in the currency.

The Middle East faced its own challenges, from political to economic. Some of the largest economies were still adjusting to Value Added Taxes, which were introduced in 2018 and increased prices for the normal citizens, thereby dampening demand. The Middle East was also affected by a softer oil price. While the big price war erupted in 2020, there were signs of weakness in the market in 2019, and the average prices dropped by about 10% for the year. Economies of this region are closely linked to the price of oil and this drop clearly affected spending in this region.

Europe and Japan also faced trade uncertainties, and some weakness in their respective currencies. Japan also increased sales taxes in October, a move which affected sales during the last quarter, an important sales season.

Overall, at a retail level, jewelry sales for the year dropped by about 2.7% to close at about USD 76.05 billion, with only the US market showing a slight increase in consumption.



LGD No Longer a Taboo

2019 was also the year when lab-grown diamonds (LGD) became a mainstream product. De Beers entered the market with the launch of Lightbox, prompting a rush of mid-stream players keen to get in on the act. This brought greater financial muscle to the LGD market.

Many large retail chains started testing the waters and it quickly became commonplace for consumers to find both natural and LGD diamond products side by side in the same outlet. Lab-grown diamonds were no longer a niche product.

Competition in the LGD market also made the product more affordable. LGD pioneers sold at slightly lower prices than natural diamonds, but the discounts increased as competition grew. The price of LGDs - especially smaller ones produced through the HPHT process and mainly sourced from China - dropped as availability and penetration at retail level increased.

Every item of LGD jewelry sold means one less sale of a natural diamond. When the consumer walks through the doors he or she is looking to buy jewelry. Both products are competing for the same consumer dollars, and as the industry increases in size, LGDs will cut deeper into natural diamond sales.

Destocking Actions

The less-than-stellar retail sales during the 2018 season and in the early part of 2019 forced retailers to re-evaluate their stocking positions. In the US, chain stores pushed some inventory back into the pipeline and adjusted their new orders to keep stock in line with the consumer demand. There was also a shift towards online sales channels and increased shelf space dedicated to LGDs, both of which require less stocking of natural diamonds. As the sales mix changed, stocks in the pipeline at retail came down.

A similar destocking process was observed in China, the Middle East and India. Overall business uncertainty meant retailers scaled back aggressive growth plans and the resultant excess stocks were absorbed through the year.

The destocking at a retail level, as well as the improvement in the sales of LGDs meant the polished diamond demand from the mid-stream was significantly subdued and dropped nearly 9.5% to about USD 17.93 billion.

Midstream Overcapacity

The midstream entered 2019 on an optimistic note, having gradually built up some stocks toward the end of 2018. In 2018 new mines had entered full production and rough sales were enthusiastic. However, the subdued US season meant that the replacement demand in Q1 of 2019 was slow, leading to increased stocks, which filtered through to softer prices.

The midstream adjusted to the lower demand and reduced inventories accordingly. Excess stocks, mainly in the cheaper American goods, took longer to absorb and meant rough purchases in these areas were reduced even more than in other areas, like certified goods.

Midstream Liquidity & Profitability

The midstream destocking and reduction in its activity also led to a reduction in business's current assets. This directly translates to the level of bank lines required. As companies slimmed down, their need for credit also reduced, as payments were used to bring down the debts. Overall debt in the midstream reduced as a consequence by nearly USD 1 billion, reflecting lower business volumes.

Banks periodically review their borrowing limits. During 2019 the industry had more limits than required, based on the business volumes, so liquidity was not a major issue for the industry.

Profitability remained the major issue for the midstream. As the year started off on a weak note, the higher inventories necessitated a drop in polished prices, which directly affected the profitability of the polishing companies. This pressure was sustained pretty much throughout 2019, leading to low production right through Q3.

As an aside, the lower profitability margins also prompted large midstream companies to seriously consider investing in the lab-grown diamond pipeline, where margins were considerably healthier and the industry was still in growth mode, with companies adopting different strategic means to enter that space.

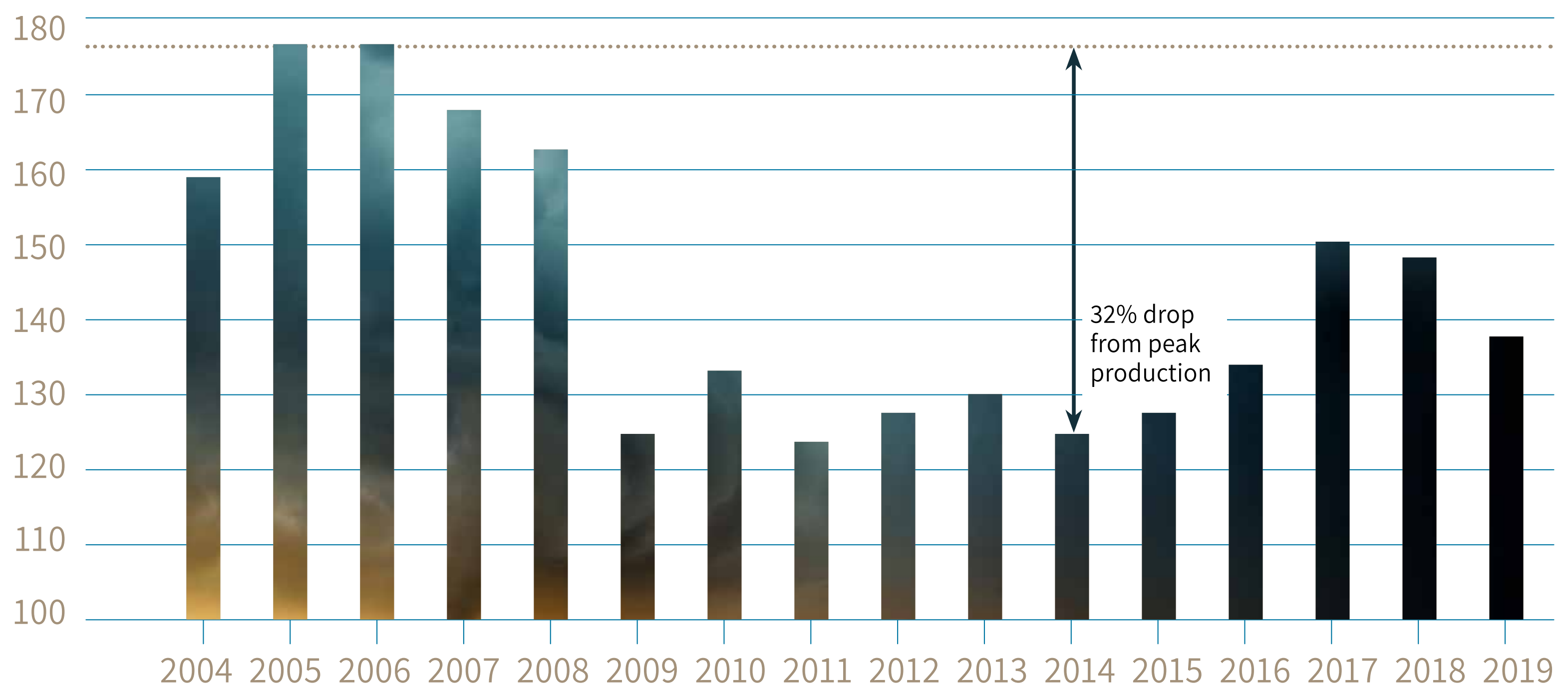
Polished prices, and hence profitability, picked up after November, and manufacturing activity started in earnest only after the Diwali break. This led to a pickup in rough manufacturing, as well as a renewed bout of rough purchases.

Rough Demand Dented

As the demand and stocking actions taken downstream rippled up through the pipeline, the rough demand felt the greatest impact. Rough purchases by the midstream were the lowest in a decade, and were the lowest after 2009, when the full impact of the financial crisis hit the diamond pipeline.

Annual Global Diamond Production

Source: KP Annual Production Statistics



The impact felt by individual miners was different, because of the actual mine output by the miners. As expected, the cheaper rough, mainly used to produce American goods, felt the greatest impact, while the effect on larger certified goods was less severe. The impact of polished movement on rough is affected by both the length of the pipeline as well as the polishing value addition; an increase in both these factors for this specific rough category, meant greater impact.

From a company perspective, a few of the new Canadian miners, who primarily produce cheaper goods, faced severe financial issues. They struggled to adjust to revenues significantly lower than forecast and at times below operating requirements.

While a majority of the mid and small miners continued to sell rough at market prices, De Beers and Alrosa, who account for nearly two thirds of the rough supply, decided to take a different strategy. They generally held their prices, but allowed customers to defer or turn down purchases, restricting supply to the market, as most long-term customers decided to defer their rough purchases, allowing greater buoyancy in the prices.

Rough prices were finally eased by the two largest producers when the market improved and sales started to move. The impact of this decision was that the market share of both the primary producers dropped below 60% for the first time after 2015, another year of low sales. However both producers kept operating their mines pretty much as usual, which led to both of the producers stockpiling rough diamonds within their operations. It is estimated that by the end of 2019 they had USD 1-1.5 billion of unsold rough diamonds between them, which they expected to sell in 2020, once the market conditions improved.

All told, the rough sold by the miners to the industry dropped about 16.4% and was at about USD 12.55 billion for the year. A tough year indeed for mining!

Economic Impact

In for the Long Haul

As we get into the main 2020 season, we increasingly fall short of reasons to be optimistic.

- Many regions are experiencing second or third waves of infection, forcing more lockdowns and resultant economic impact
- In the US, the support package was quite generous. For many low wage earners, the benefits were more than they would have otherwise earned: This package expired in mid-August and negotiations are still underway for a follow-on package, airlines are expected to start furloughing or sacking workers in October, unless the support package is announced
- Families will revisit their spending and saving patterns because of the shock of Covid-19 – and may well spend less as a result.

The hopes of the world reside on a vaccine being approved for public use by health authorities. Experts believe that even if a vaccine is approved its delivery to a large enough population will take a good portion of 2021.

Restarting the global economy will not be as easy as politicians suggest. Industries and consumers are likely to require support in some form till then, but many countries might need to keep fiscal realities in mind.

From an industry perspective, we need to be aware of the potential “revenge travel”, just as we gained from the “revenge spending” earlier this year, especially as things open up during 2021.

The sad fact (for some) is that non-economic, non-efficient, non-productive elements in the pipeline will have to close operations, and it will not be only limited to mining companies. That is the reality of becoming a market driven industry.

Looking Forward

As mentioned, our base forecast for 2020 continues to have the drop in retail demand pegged at about -20%. The implications of this are:

- 32% drop in polished sales
- 35% drop in rough demand

This might seem a little counter-intuitive, because normally the rough sales sway much more than the polished sales. However, we have 2019 to thank for that. If you consider the drop from the 2018 rough sales, it does work out to a nearly 47% drop. The drop in rough sales in 2019 cushioned the impact of the current crisis for the rough producers, though it might be small consolation for producers struggling to run their mines at current volumes and prices.

2021 promises a much brighter outlook. While global GDP will remain at or below 2019 levels, the industry will see the positive stocking effects at all parts of the pipeline, from retail till rough. We estimate that both polished sales and the rough demand will be higher than 2019, even with conservative growth in demand growth, and possibly at a level between 2018 and 2019. So there is something to look forward to after all.

As the industry ramps up, the challenges will shift to other areas, such as liquidity and the availability of finance. In 2019 and 2020 the industry has been on a destocking cycle, wherein stocks and receivables reduce, which goes into paying down bank debt. Our estimates show the industry would have brought down its debt by nearly 30% over these two years. This was a godsend for the banks, given how wary they currently are of our industry.

As we move back into the stocking cycle, the industry will need credit. While the requirement will still be below 2018 levels, the industry will still require more than 30% more funding. Whether the banks and financial institutions are keen to do so needs to be seen. Lower funding availability will reduce the ability of the midstream to stock up, affecting rough sales and prices.

All said and done, we continue to be one diamond pipeline. We all serve one purpose, which is to get the diamonds to the consumers. If the demand fails or the pipeline breaks, we all will ultimately suffer. In these trying times, it's important that all elements in the pipeline continue to remain profitable and healthy.

After a disastrous 2020 we face an uncertain future. But we should still be thankful for 2019. It was a tough, there's no question about that. However, it left us in a stronger position to face what's coming... as we become a truly market-driven industry.

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