IDEX
DIAMOND TRADING NETWORK

2020 PIPELINE
Pandemic - Blessing in Disguise for the Industry?

By Pranay Narvekar
and Chaim Even Zohar

STUDIO SPECTOR

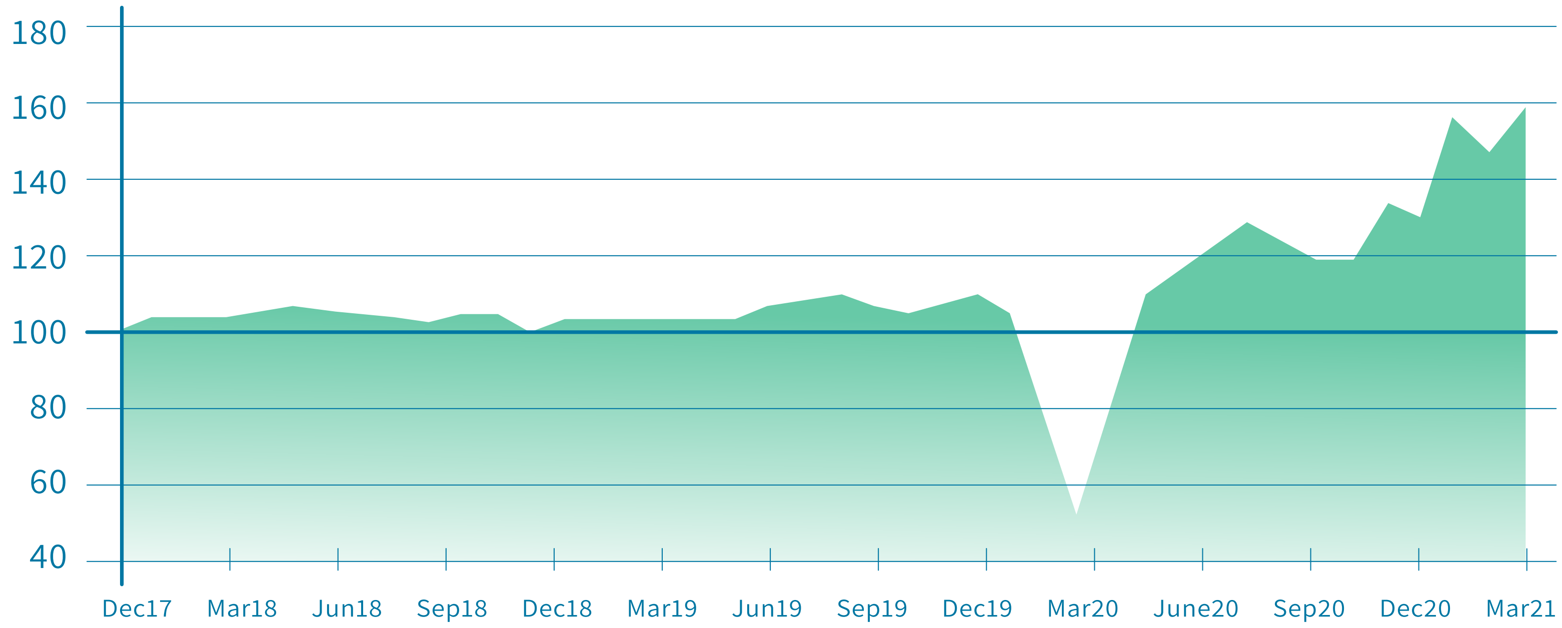
2020 always had a nice ring to it and in the runup to it, many entities, both companies and international bodies drew up their vision statements for Twenty-Twenty. However, 2020 turned out to be quite the contrary and will be remembered for a long time for all the wrong reasons. The Covid-19 pandemic and the resulting actions taken to tackle the same had an indelible impact on the way we live and work, while proving to be a shock to the entire global financial and economic system.

The world economy as well as the diamond pipeline faced a sudden stop around March 2020, as the Covid-19 infections spread, and governments-imposed lockdowns of various types. However, the recovery seemed to be equally quick at least for the industry, though not simultaneously in all geographies. In most retail markets, sales seemed to match those of the previous year within about 4-6 months, and in some cases continued to grow from strength to strength. In the mining areas Covid challenges impacted production and distribution, causing additional pipeline incongruities.

It is instructive to take a quick look at how the U.S. retail sales for the industry rebounded. U.S. accounts for half of the industry sales and the retail market bounced back quickly and continued its stellar performance even into 2021. The one thing that didn't bounce in the United States were the 169 million stimulus checks, totaling $395billion, which the IRS has sent out to U.S. taxpayers whether they needed it or not. The new Biden administration passed already the American Rescue Plan Act of 2021 providing $1.9 trillion in funding, program changes and tax policies to help mitigate the effects of the pandemic, which means that the bonanza in the U.S. retail markets will solidly continue throughout the current year, irrespective of any Covid-variant.

While most analysis looks at this from a year-on-year percentage perspective, it is instructive to view these sales from a longer-term view, as given the low base in 2020, some of the y-o-y percentages might look extremely high. The U.S. Bureau of Economic Affairs provides seasonally adjusted consumption expenditures for jewelry and indexing the same to December 2017 illustrates just how massive this jump in consumption is for the industry.

Seasonally Adjusted Consumption Expenditure



Source: Bureau of Economic Analysis, U.S. Department of Commerce

This kind of jump in retail demand is quite frankly unprecedented! It pains to admit that Covid-19 turned out to be a blessing in disguise for the diamond business because nothing is worth the human suffering that the pandemic has brought. We are also careful not to talk, as is very popular at the moment, about the "new normal". Nothing is normal at the moment – and analysts are making fortunes conjecturing how the world's economy and businesses will evolve. We are not joining these prophets. We know that in a normal year an increase in high single digits is sufficient to energize the entire industry.

To put this in perspective, the last time we saw a rapid increase in percentage terms was in early 2011. During that period, this same U.S. index would have shown an increase of 12% over a 4-6 month period, a far cry from the 40-50% increases. It should be noted that the 2011 surge was also driven by serious rise in jewelry consumption in the rest of the world and especially China.

Over the last many years, the authors have repeatedly highlighted the fact that the industry was losing its share of wallet. Consumers seemed to have lost interest in the category as the pace of innovation seemed to be slow, compared to other areas like electronics and gadgets. The meagre marketing efforts of the industry through various bodies looked like trying to slow the decline, rather than aggressively increase the market.

The last six months have suddenly dispelled the gloom and the future for the entire industry suddenly looks much brighter! This has an immediate impact on the entire pipeline. As the retail pull-through increases and more jewelry gets sold, jewelers start to place replacement orders, which ripple through the entire pipeline, leading to better prices in polished, a financially healthier mid-stream, as well as finally showing up in the rough demand.

The current scenario for the industry seems like a blessing to everyone, something which was unimaginable 12 months ago, when we were in the depths of the pandemic, with widespread lockdowns across the globe. The question on everyone's mind is whether this is just another flash in the pan or whether the industry had found its mojo again. What we know for sure is that Covid-19 has not lost its mojo – it's fighting the vaccines and developing more lethal variants continuously.

On a governmental level the stimulus injections have triggered global governmental debts to some $281 trillion by the end of 2020 – and climbing. Out of fear for a loss of faith in currencies, the IMF and other global financial institutions consider this debt to be "sustainable" and there is room for continued growth. But how long can one live in a land of fools? Diamonds may again, and maybe with more conviction than ever, become not just an inflation hedge but rather a sure (and rare) source of sustainable wealth. The pandemic can lead the world still into very unexplored paths.

"Nothing is normal at the moment – and analysts are making fortunes conjecturing how the world's economy and businesses will evolve. We are not joining these prophets."

TACY'S 2020
DIAMOND PIPELINE

In US$ billion | prepared by Pharos Beam Consulting LLP.

IDEX
DIAMOND TRADING NETWORK

	US$ billion
Direct costs of rough production	5.9
Rough production value	9.43
Mines sales to industry	9.37
Net rough used for local production	10.52
Value of polished production	13.37
Polished sales	14.22
value of recycled polished	0.25
Retail Diamond Content	17.07
Retail of Diamond Jewelry	65.02

Direct cost of production
Including stock value depreciation

Rough production value

AUSTRALIA	ANGOLA	DRC	NAMIBIA	BOTSWANA	S. AFRICA	RUSSIA	CANADA	ZIMBABWE	LESOTHO	OTHERS
0.12	1.1	0.14	0.74	2.58	0.98	2.35	0.95	0.11	0.15	0.21

Mines sales to industry

INDEPENDENT	ALROSA	DE BEERS
3.87	2.65	2.85

Net rough used for local production

BELGIUM	ISRAEL	INDIA	USA	S. AFRICA	CHINA	RUSSIA	OTHERS
0.13	0.29	8.48	0.09	0.52	0.51	0.18	0.32

Value of polished production

BELGIUM	ISRAEL	INDIA	USA	S. AFRICA	CHINA	RUSSIA	OTHERS
0.16	0.38	10.65	0.11	0.62	0.64	0.42	0.39

Rough gem synthetics

USA, SINGAPORE, MALAYSIA, RUSSIA & OTHERS
≥ 0.7

POLISHED SYNTHETICS
≥ 1

value of recycled diamonds
(consumer sell backs) re-entering pipeline

Retail Diamond Content

USA & CANADA	EUROPE & SA	HK/CHINA TAIWAN	JAPAN	INDIA	GULF & TURKEY	REST OF WORLD
9.02	1.48	2.1	0.88	1.12	1.21	1.26

Retail of Diamond Jewelry

USA & CANADA	EUROPE & SA	HK/CHINA TAIWAN	JAPAN	INDIA	GULF & TURKEY	REST OF WORLD
35.33	4.73	8.94	3.05	4.02	5.47	3.48

Retail in 2020

Let's stick to the known facts. 2020 was projected to be a year of revival for the industry, which went through a tough period in 2018-2019, when demand reduced and retail destocking added to the industry woes. Good sales during the 2019 season, provided the tailwinds to the industry and 2020 began at a brisk pace, till the uncertainty of the Covid-19 crisis started creeping in.

As the main markets across the world started introducing lockdowns to curb the health crisis, retail sales started dropping, with the Chinese market facing the first wave followed by all the major markets. The U.S. which had a relatively mild lockdown, saw retail sales dropping to half in April, while markets like China, India and EU probably had greater drops.

Surprisingly, retail markets rebounded quickly as the lockdowns were removed. The U.S. which accounts for half of the retail diamond sales, saw year-on-year sales crossing that of the previous year by June. This meant that the impact on sales were mainly felt in the first and second quarters only. The Chinese market also showed a sparkling recovery especially in the mainland China region, although it is still dealing with the loss of business in the Hong Kong market, due to travel restrictions as well as the political climate. The Indian market too rebounded, but a little more slowly, as the lockdowns were longer with gold jewelry getting a bigger boost.

As stores shut down, there were serious liquidity concerns faced by the retail stores. This was especially true of stores which had leased their premises, as this contributed to a significant cost element. In the U.S. the prompt government aid package did help businesses to keep afloat, by getting access to loans to finance their operations as well as other subsidies. Other countries also rolled out business rescue packages. Businesses were also able to renegotiate some of their lease payments with the landlords while also reducing some of their other operating costs, which helped them get through the crisis. This was evident in the fact that there was no undue spike in bankruptcies and store closures.

During the peak of the lockdowns, there were delays in payments to vendors, but the quick rebound in sales meant that the businesses were able to generate liquidity fairly quickly by running down some of their inventories and catching up on their payments. The surge in retail sales during the latter part of the year coupled with the operational improvements also meant that retail businesses are seeing some of their best operational performance in years. This trend has been further reinforced in the current year and most retail businesses currently are enjoying healthy balance sheets, as compared to previous years.

Overall the global retail sales were down about 14.5% and clocked in at about USD 65 billion, close to the most optimistic estimates for the year!

"Overall the global retail sales were down about 14.5% and clocked in at about USD 65 billion, close to the most optimistic estimates for the year!"

Midstream

Crisis and renewal

At the beginning of 2020, the mid-stream was on course to meet the higher demand predicted for 2020. The mid-stream had tightened their businesses and had de-stocked by October of 2019 and from then on, the re-stocking cycle had started. The first 2-3 months of 2020 reinforced this restocking cycle, till the pandemic hit the mid-stream in late March.

The mid-stream suffered on multiple fronts from the pandemic. The near sudden stop to retail sales meant that the polished diamond orders and sales dried up almost immediately. With retail stores under lockdown and delayed payments, cash flows also started to become major issues. The situation was compounded by the strict lockdowns imposed in India to fight Covid.

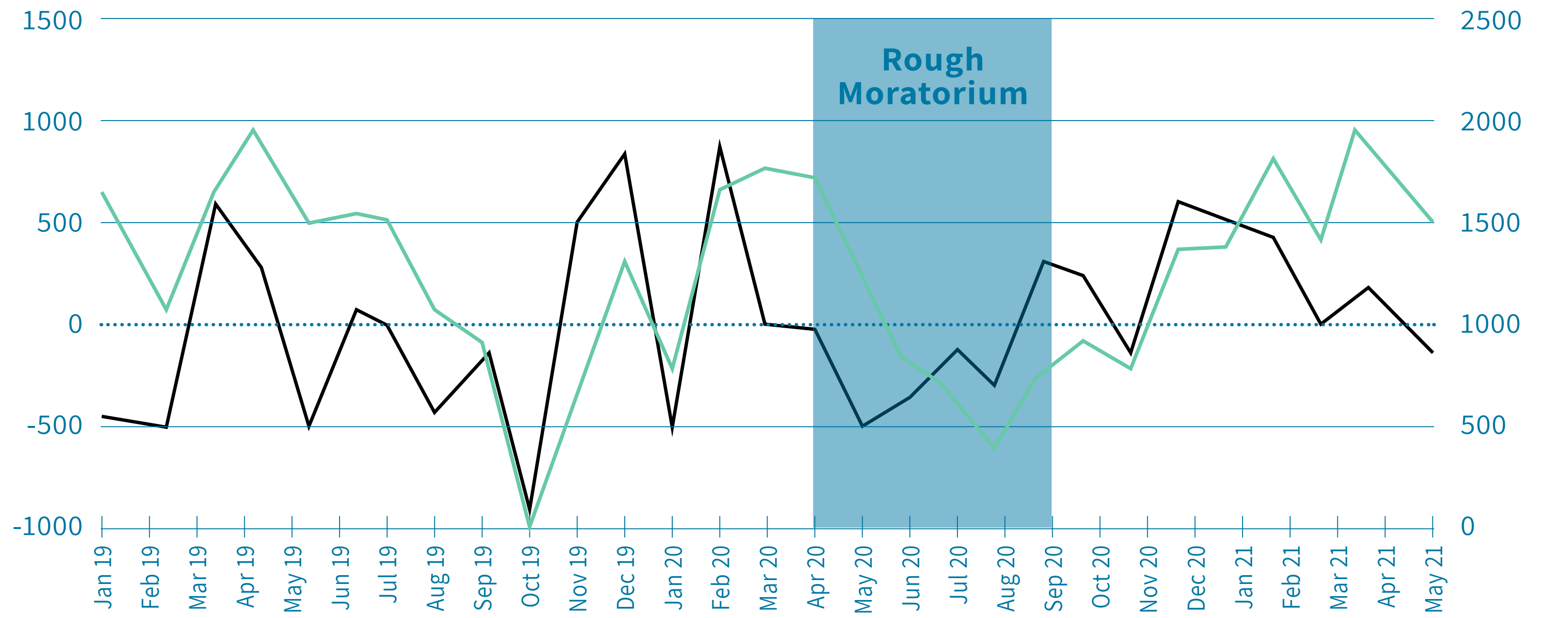
Mid-stream sales were also dependent on buyers travelling to trading centers to inspect and buy the required polished. With global travel bans, this meant that a large part of the buying activity came to a standstill, at least till buyers worked our arrangements with the sellers.

The Indian polishers have always come together in difficult times, and 2020 was no different. They decided to go in for a voluntary moratorium on buying of rough, which was largely in effect from April to July. During this period India as a whole imported only about 15% of rough, which it would have otherwise imported. The Indian industry's hand was, in a manner of speaking, forced because factories were either shut down, or were operating at low levels due to distancing norms as well a large chunk of the labor force having moved back to the villages during the lockdowns. Hence, even if companies wanted to produce diamonds, their capacities were severely limited. Coupled with the liquidity pressures from the banks, it made prudent sense to go easy on the rough purchases.

This move was opposed by the large rough producers, who called for the industry to "work together" through the crisis, as this step meant that they registered almost no sales in the second quarter. Incidentally, in later sponsored industry reports this was glossed over. Producers were praised as to how their "response at the start of the Covid-19 crisis helped mid-stream players weather the worst of the storm" by canceling sales and allowing clients to postpone rough purchases. Talk about making a virtue out of a necessity!! However, in retrospect, it does look like it helped the industry get on its feet much faster.

It is illuminating to see how the estimated rough stocks in India as a whole moved over the last 2 years. As mentioned, October 2019 was the end of the destocking cycle, and we can consider that to be the zero line and look at the stocks.

Net and Cumulative Monthly Movement of Stock



Source : Bureau of Economic Analysis, U.S. Department of Commerce

As can be seen, by March 2020, stocks had nearly risen to their 2019 peak, in anticipation of the 2020 sales, before dropping during the moratorium period. These again started climbing, and seem to have reached the peak levels again.

The health of the mid-stream is determined by the polishing profitability and more critically diamond prices. Typical polishing margins in the businesses are in the low single digits and hence a 10% drop in stock price can wipe out years of business gains. The rough moratorium helped the mid-stream ensure that the liquidity pressures were limited, as there was no rough and stock to be financed. This in turn reduced the pressure on companies to have to sell at any cost ensuring that the price of polished did not crash when the market was illiquid, preventing a serious balance sheet crisis for the mid-stream.

As the retail sales grew from strength to strength, replenishment orders started filtering through. Indian mid-stream had destocked sufficiently by August and started buying rough to ramp up their production to meet the ongoing sales demand. With large rough producers following a price-vs-volume strategy, the offtake started off a little slower, before picking up steam.

The mid-stream managed to sell about USD 14.2 billion or polished, or about 20.7% below 2019 sales, despite 2019 itself being considered a lousy year for retail.

“The mid-stream suffered on multiple fronts from the pandemic. The near sudden stop to retail sales meant that the polished diamond orders and sales dried up almost immediately.”

Mid-stream Deleveraging

As mentioned, stock prices can make or break the balance sheet of the mid-stream, and the actions by the mid-stream ensured that the price drop remained within an acceptable level. The retail surge also meant that by the end of the year, overall diamond prices were almost at par with those at the end of 2019, if not higher, a remarkable achievement, considering the chaos of the second quarter!

As with retail, the mid-stream too brought in additional efficiencies into their operations including pruning of the workforce as well as reducing travel and marketing expenses. This was certainly helped by the fact that industry shows and events could simply not be held due to the Covid restrictions in place.

The pickup of polished demand, also allowed the mid-stream to destock. During the destocking process, as inventories are liquidated, bank lines are repaid, leading companies reduce their borrowing. Our estimates show that the industry was able to reduce its borrowing by nearly 20% during the course of the year, driven by a never before combination of destocking and better profitability (in the second half) with almost no stock loss being booked!

We believe that the industry leverage is probably at the lowest level, even better than what it was at the end of 2011, which was the stand out year for the industry in recent memory.

As a result of the destocking, rough sales by miners dropped by about 36.7% and clocked in at about USD 9.37 billion for the year.

"Typical polishing margins in the businesses are in the low single digits and hence a 10% drop in stock price can wipe out years of business gains."

Rough producers

Saved by the bell?

Producers had weathered a rough 2019, as the mid-stream deleveraged and rough purchases dropped to the lowest level in a decade. With good sales recorded in the 2019 season, rough diamond sales were looking up and rough producers were looking to make up lost ground, till the pandemic struck them hard by mid-March.

As mid-stream ground to a standstill, and the Indian moratorium kicked in, almost no rough was sold for about 2-3 months. For a few producers who were already facing serious headwinds and profitability issues in 2019, as well as those with a high leverage, this proved to be the final straw. They had to go in for temporary mine closures as well and also rework on their financing agreements. This forced these mines to stop production for an extended time during the year, at least till they were able to do the necessary restructuring. In a way, this forced reduction of supply eased the pressure on the 2 leading players to cut production.

Among the larger producers, generally most of the mines were able to operate, except for short periods if Covid cases were detected in a specific mine. While they continued to operate at slightly lower production levels, the impact of lower production was mainly limited to Q2. The mid-stream actions in Q2, lifting of lockdowns and the sustained consumer demand in the second half of the year, significantly revived the diamond markets in the second half of the year, and secondary market box premiums by end of 2020 and continuing into 2021, provided testament to the enhanced rough demand.

Interestingly, the two leading producers seem to have taken a contrasting view on their production strategies during the year. De Beers produced about 25m carats, while selling about 20m carats during the year, and stockpiling the remaining production. A major chunk of this stockpile has been sold down during the first quarter of 2021. Alrosa, on the other hand, came into 2020 with a sizeable stockpile from 2019 and for 2020 produced only about 30m carats while selling about 32m carats, meaning that they actually were able to reduce their stockpile during a year of rough sales!

It shows that Alrosa was quicker on the gun, and decided to prioritize sales in the latter half of 2020. Alrosa was able to get to within breathing distance of De Beers' rough sales for 2020 with the last 4 months of 2020 accounting for about 55% of the sales for the year!

A look at projected production shows that Alrosa is forecasting production to be lower than De Beers, which seems inexplicable, especially given that Alrosa rough sells at a lower price and that they generally produce about 30% more than De Beers. The lower projected production has the potential to destabilize rough prices in certain categories of rough in 2021, but we believe that Alrosa will significantly increase their production target for the year, as they do have the spare capacity for the same.

Lab-grown Story

Growing into its own market

Lab-grown diamonds are an integral element of the diamond pipeline, at least at the retail level. While there might be some overlap between the polishing as well as polished and jewelry wholesale areas, these are still distinguishable. At the retail side, while there might be a few exclusive outlets or websites, generally lab-grown diamonds are starting to find a foothold in a larger chunk of the jewelry stores, at least in the US, where the category is the most mature.

The lab-grown retail market is still very much in its teenage growth years, with many brands trying to establish themselves. Competition is still about market penetration and spreading the distribution across the markets, along with filling the pipeline. It is to be seen how many survive over the next 5 years. While the retail growth shows promise, it still is very much a stocking demand. Overall, lab-grown diamonds grew in market share during the year, simply because their demand is primarily dependent on the U.S. and did not drop as much as that for natural diamonds.

The technology is showing signs of maturing, with quality differences in the products narrowing. At the current stage, the “patent wars” in the lab-grown industry are being fought, will all parties trying to get a competitive advantage over their competitors. De Beers had a mixed victory over IIA technologies in Singapore early last year, while recently WD Lab-grown Diamonds lost a lawsuit against Fenix in the US.

The bulk of the rough lab-grown diamond production continues to come from the HPHT process, dominated by the Chinese industrial producers. The bulk of the value comes in from the CVD production, which gives better and larger stones, and that production is more widespread, with capacities being set up in India at a fast clip.

“Lab-grown diamonds are an integral element of the diamond pipeline, at least at the retail level.”

Is the Industry Performance **sustainable?**

There is no doubt that the industry has performed spectacularly at a retail level over the last 6 months and is witnessing one of the best periods for the industry. Many traders are reporting that they have never been as busy in June as they currently are.

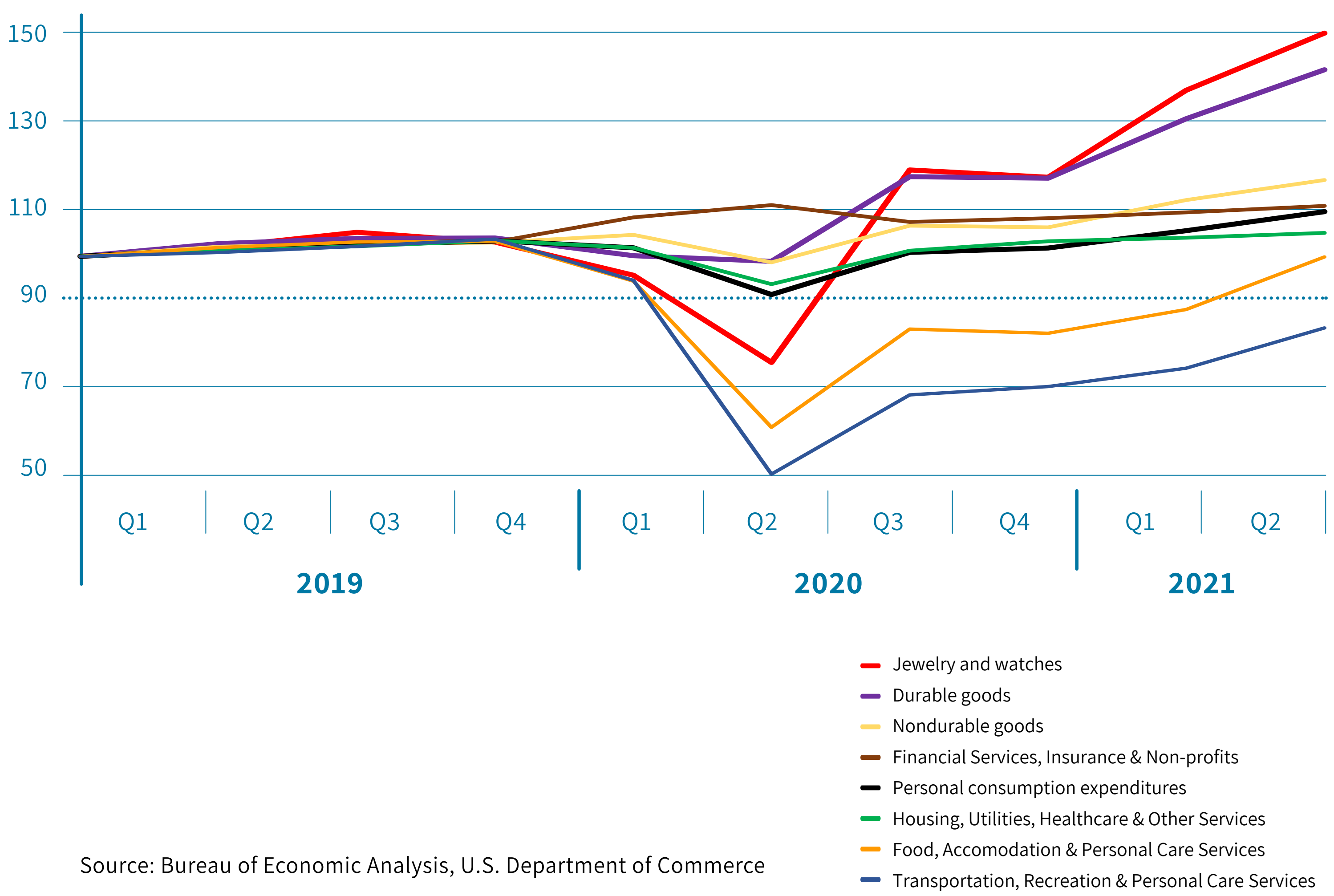
Our current favorite indicator for mid-stream activity and health is undoubtably the backlog at the grading laboratories. A longer delay signifies increased activity levels in the mid-stream, and even on that count, the industry seems to be doing swimmingly!

However, there is a difference of opinion in the industry. On one hand there is unbridled optimism with claims of the industry outperforming other industries and that the industry has been able to better engage with the customers and even attract millennial customers during the crisis. On the other side, we have other industry leaders and media saying that this is a flash in the pan and the market will slow down going forward. Even the leading retailers in the U.S. have struck a cautious tone about future sales, despite record setting numbers in the first half of 2021.

To understand whether we, as an industry, have truly outperformed, we can once again look at the U.S. market data from the U.S. Bureau of Economic Affairs. In analyzing any data the inherent seasonality of any demand proves to be a challenge, as the annual pattern each industry varies. However, the seasonally-adjusted consumption expenditures data does this for us and is a useful gauge of how the personal consumption has changed over the period.

What we would specifically like to do is to compare the jewelry industry performance with that of other goods and services. We have grouped together some services for it to better reflect the comparison and impact of the pandemic. The data has been presented at a quarterly level so as to damp out any monthly fluctuations, and focus on the overall trends.

Seasonally Adjusted Consumption Expenditure



Source: Bureau of Economic Analysis, U.S. Department of Commerce

There are some interesting observations which can be made on the trends

- The pandemic and the resultant lockdowns to contain it affected overall movement and activity in the economy, which is visible in the dip in the second quarter. Currently the personal consumption index is about 10% above that of 2019 Q1 baseline.
- As we all know, the service industries were most affected by the lockdowns and travel restrictions and these include transportation, recreation, personal care, food and accommodation services.
- Housing, utilities, healthcare and other services have held steady during this period. These are the basic requirements and would be expected to do so. This block accounts for 40% of the overall personal consumption expenditure in the economy
- While non-durable goods have shown good increase, durable goods have by far outperformed other categories of consumption. U.S. consumers seem to have a new-found love for acquiring physical durable.

While the jewelry category does stand out as the best performer in this chart, it is to be noted that the industry's performance is in line with that of other durable goods. If you dig down deeper into the data, you will find categories like motor vehicles, a much larger industry, have outperformed jewelry. Even other industries of comparable size, be it sporting equipment, guns and ammunition or sports and recreational vehicles have performed better than our industry.

Clearly, while the industry is among the better performers, it is simply part of the "gold rush" of consumers as they spend on acquiring durable goods. It can be argued that consumers, who had saved from not spending on the services mentioned above, as well as buoyed by the handouts provided by the government channeled a large chunk of their excess funds into buying the physical durable which they had longed for, they but had not been able to buy. Additionally, the wealthy effect of the stock market boom, fueled by government stimulus and ultra-loose monetary policy also helped loosen the consumer purse strings. This also makes sense because durable goods are generally more expensive and last much longer and have a utility value over their lifetime.

There is no doubt that diamonds and jewelry have more of an emotional element in their purchase decision. During crisis, and the pandemic is no different, humans do look for emotional connect and jewelry is simply a beautiful way to express it. It is natural that couples who have been stuck at home during the last year have bought jewelry to express their love!

The return to normalcy is not going to be a sudden one, unlike the onset of the pandemic. As vaccinations across the globe are slowly rolled out, businesses will gradually revert back to the previous behavior over the course of the next 2-3 years.

As both the disposable income reduces (with travel and other areas becoming prominent again) and experiential luxury market gradually increases, the share of the wallet will gain shift out of the jewelry category, something which the industry should not give up without a fight.

A similar trajectory is playing out in other major markets like China and India as well as other luxury categories. Consumers are spending their excess disposable income on these categories and it would take 2-3 years for the market to reach the "new normal".

Looking Forward

The authors had, in the 2019 pipeline article, mentioned that 2021 would be a very good year for the industry, with rough and polished sales expected to between the 2018 and 2019 levels. The sustained retail boom in the first half has meant that the performance is likely to be even better, barring any sudden crash of world economies.

We expect that the polished sales for the industry would clock in at about USD 20-21 billion, while the rough sales should come in around USD 17 billion, with De Beers and Alrosa accounting for about USD 10-11 billion. It is likely that the current market euphoria would continue into Q4 before quieting down by the end of the year.

While this much is clear, prices on the other hand, are a representation of the demand supply mismatch. With a healthy demand and an absence of supply, prices would per force rise. In the initial phase of every upcycle, prices remain stable, as producers run down their stockpiles to meet demand.

We are currently in the latter phase of the cycle, wherein most producers would have exhausted their built-up supplies, and the increased demand would directly reflect on the prices. Recent history has taught us that the best prediction for the end of a boom cycle is clearly a sharp increase prices and euphoria in the rough market, though we are not there yet!

In our industry, a good year always sets the stage for the next year's underperformance. Traditional wisdom has it that when the going is good, strap in an get ready to ride the rollercoaster because 2022 will be a different story! In a market where producers still can manipulate the supply and demand fundamentals, the pandemic remains fully out of control – in spite of governmental assurances stating otherwise. When the widely predicted holiday travel book may fizzle out, beautiful and expensive diamond jewelry may become the consolation prize of choice to somehow make disappointed housewives and brides to be somewhat happier. This may give new meaning to the social welfare the diamond abundantly spreads around.

"Traditional wisdom has it that when the going is good, strap in an get ready to ride the rollercoaster because 2022 will be a different story!!"

Chaim Even Zohar

Pranay Narvekar