IDEX
DIAMOND TRADING NETWORK

2021 PIPELINE
LAMENTING THE NATURAL PRODUCERS' MISSED INCOME

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STUDIO SPECTOR

It is well known that in 2021, the diamond midstream and downstream sectors experienced what was probably one of their best years in recent memory, right up there alongside 2011. In the euphoria, US$20 billion of potential and thus unearned income was lost as a ripple effect of the legitimization of LGD by De Beers. High Street jewelers and high-end jewelry chains, traditionally the greatest defenders of the natural product, have lost their inhibitions and are now the main LGD drivers, without reputational fears.

Nevertheless, the entire industry not only saw a surge in sales after the Covid outbreak in 2020, but also experienced one of its most profitable years, something which it had been yearning for. 2021 helped the industry rightsize its inventories and bring the overall business model back in line with what it should be.

De Beers, champion of the natural diamond industry, triggered the universal acceptance of the competing LGD product with the launch of its Lightbox range of diamonds. It is now apparent this move heralded a point no return for the massive uptake of the LGD industry and the natural diamond industry will now have to live with the implications. Those who have followed our annual analysis for many years will remember that we have said that eventually the price differentiation between natural and LGD will disappear, and the market will know only one product, called diamonds. Fortunately, we aren't there yet…..

With the launch of Lightbox, De Beers said it hoped to keep LGD prices in check and to corral LGD into the impulse-purchase category. All this was backed by a lot of research. The reality is quite different, with a bulk of sales of LGD catering to the bridal demand! Just read one of many headlines on bridal websites: "These Are the Best Places to Buy Lab-Grown Diamond Rings", or "maximize your budget without sacrificing style". We find it difficult to believe that De Beers' research missed this outcome.

Pricing policies in natural and LGD diamonds are not all that different. The bulk of LGD sales by value are in the larger stones (pointers and carat-plus stones) and if LGD stones were sold at natural prices, the size of the diamond pipeline would probably nearly double from US$ 22 billion of polished sales to US$ 40 billion. While it can be argued that it might not necessarily be a correct comparison, it highlights how big a dent the LGD market has made to the natural diamond industry.

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It is just a matter of time before countries that produce natural diamonds fully realize the irreversible damage the legitimization of lab grown diamonds has caused to natural diamond pipeline. In any case, it is probably too late for Botswana and Namibia to rebel against De Beers.

As the producing countries have also seen a steady surge in demand, they may find it difficult to measure the "unearned potential income". The same counts for achievable rough prices; without the LGD alternative on the market prices would have risen far steeper. Natural producers are the only pipeline participants who are tied to the natural diamonds. All others, including De Beers, are enjoying the LGD fruits.

A Spectacular 2021

For the diamond industry, the US is the primary market for diamond jewelry which accounts for over 50% of the global market. In 2021, the share of the US moved up from about 54% to nearly 60%, primarily due to the spectacular growth in the US market.

Other markets also showed a good recovery post the 2020 problems and overall the retail industry showed a growth of nearly 32% as it grew to about US$ 85.5 billion. China and India were the other standout regions, with Hong Kong also recovering well.

Retailers across the world had a dream run in 2021. Not only did the sales improve, but the margins also improved across retail. While an increase in online sales meant that margins tightened, demand meant that the pricing power of the retailers increased, leading to lower discounting and effectively higher margins. Additionally lab-grown diamond (LGD) sales also went up significantly, often providing better margins than the natural product.

In polished diamonds, due to the bull-whip (or ripple) effect in the pipeline, polished increased by about 55% compared to 2020 to reach US$ 22.1 billion. This was despite the fact that retailers sold down from their built-up inventories. Part of this rise is attributable to the rise in prices, which averaged about 10-15% for the year. However there were specific areas which had a much more substantial price rise.

The Argyle mine, which provided about 2-3m carats of mainly smaller and cheaper quality polished shut down in late 2020 and by 2021 all rough from the mine was exhausted. These goods were generally used in jewelry mass-produced for the US market. The prices for these goods remained manageable for a major part of the year, but in the last quarter, as polished stocks from Argyle rough were used up, prices moved up to levels which were about 30-40% above that in the previous year.

As mentioned earlier, a big chunk of the business lost due to the non-availability of the product from the Argyle mine was made up by the LGD industry, for which 2021 was even better than the previous year. The penetration of LGD in the US market significantly increased as more stores started experimenting with keeping LGD stock, and the LGD market participants have made the most of the opportunity.

Unlike previous predictions of LGD being restricted to fashion and lower priced jewelry, it was seen that just like natural diamonds, LGDs were also being bought in significant numbers by bridal customers. This implied that larger stones, including in the 2ct-plus range, remained in demand. What was noticed was that retailers were offering customers a larger LGD in the same budget, making it a value offering for customers. At the lower end of the market, LGD jewelry could offer a better-looking product than the jewelry with polished diamonds from Argyle.

While the market share of LGD based jewelry is constantly increasing, a good portion of the wholesale demand for LGDs still continues to come from introduction in new stores, rather than end-product demand. But this will change because of the sophistication and effectiveness of LGD promotions, including the marketing spend by Lightbox. Also, most of the sellers of LGD jewelry come from a natural diamond background and some of the same practices like memo offerings etc. have started to be used in the LGD industry to push sales. Actually, the very same emotional love message used for natural diamonds are now also applied to the LGD product.

Diamond polishing has been a highly competitive business with very slim margins for most of the last decade. 2021 was a pleasant exception. The generally increasing polished prices meant that polishers were able to enjoy generally much healthier margins. Apart from the margins, polishers also were able to rightsize their inventory. High demand enabled them to sell stocks which had been "non-moving" and almost all types of goods found buyers at an acceptable price.

"In a nutshell, the entire pipeline had a dream year, with great sales growth and fabulous profitability"

The increased turnover and profits, along with rightsizing of the inventory, meant that many businesses in the midstream were able to significantly reduce their leverage. The total debt in the midstream was estimated to be a little above US$ 10 billion. While this was an increase over the previous year, it came on the back of significantly higher turnovers. With low interest rates, the industry would have wanted to take on more debt – but the prevailing banking reluctance to "come back" to diamonds is still very visible. It will take time to earn back trust and confidence that were lost. Maybe this is for the better. When coupled with the highly profitable year, this meant that the balance sheet of the midstream has again become extremely healthy and the businesses more bankable. In a manner this strength allowed the companies to indulge in the speculative frenzy on rough prices in the first quarter of 2022.

Rough producers faced their own challenge in 2020, with many having to shut their mines either due to no sales or due to Covid outbreaks. In 2021, most producers could sell all the rough that they could produce. A few of the larger rough producers were able to even sell down all their excess stocks which they had built up over 2018 and 2019. Along with the sales, profitability also went up significantly for most producers, as rough prices followed polished diamond prices. But they didn't see the boom they could have had….

Overall the rough producers sold about US$ 15.47 billion of rough or an increase of about 65% in rough sales over 2020.

The rough market saw Gokhran, the Russian state treasury, sell about US$ 230 million of rough from their stockpile during 2021, which helped cool the market, especially for the smaller goods. While a couple of mines in Canada faced their own issues, Gahcho Kué and Renard both had production which is skewed to the lower end of the quality spectrum. Renard had been struggling to stay afloat, but with the increase in prices in the cheaper quality of goods, these mines and their mining companies could get a new lease of life, as the prices for cheaper diamonds are expected to remain robust.

In a nutshell, the entire pipeline had a dream year, with great sales growth and fabulous profitability for most companies across the pipeline. What is more interesting is examining some of the other factors that accounted for the industry's success.


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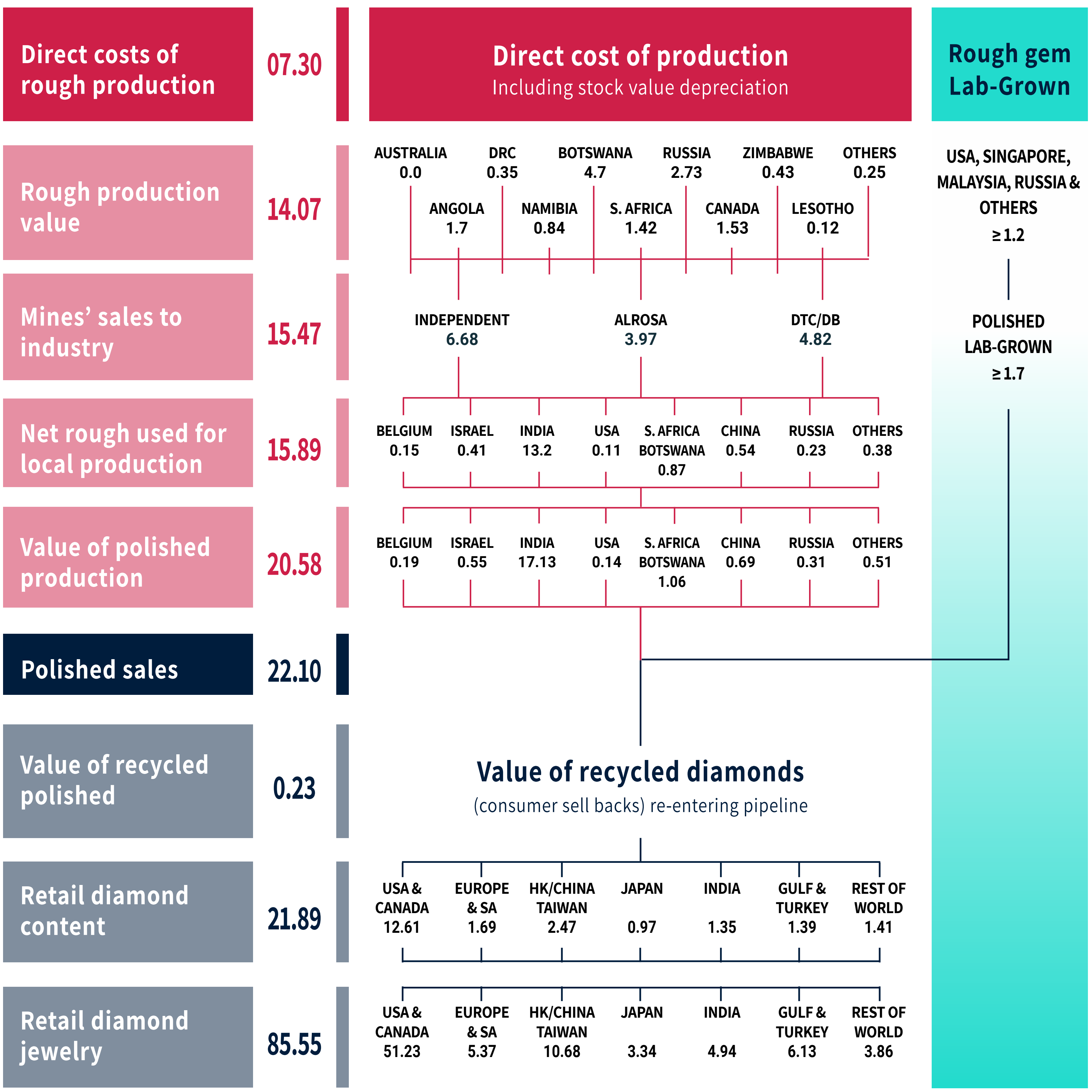
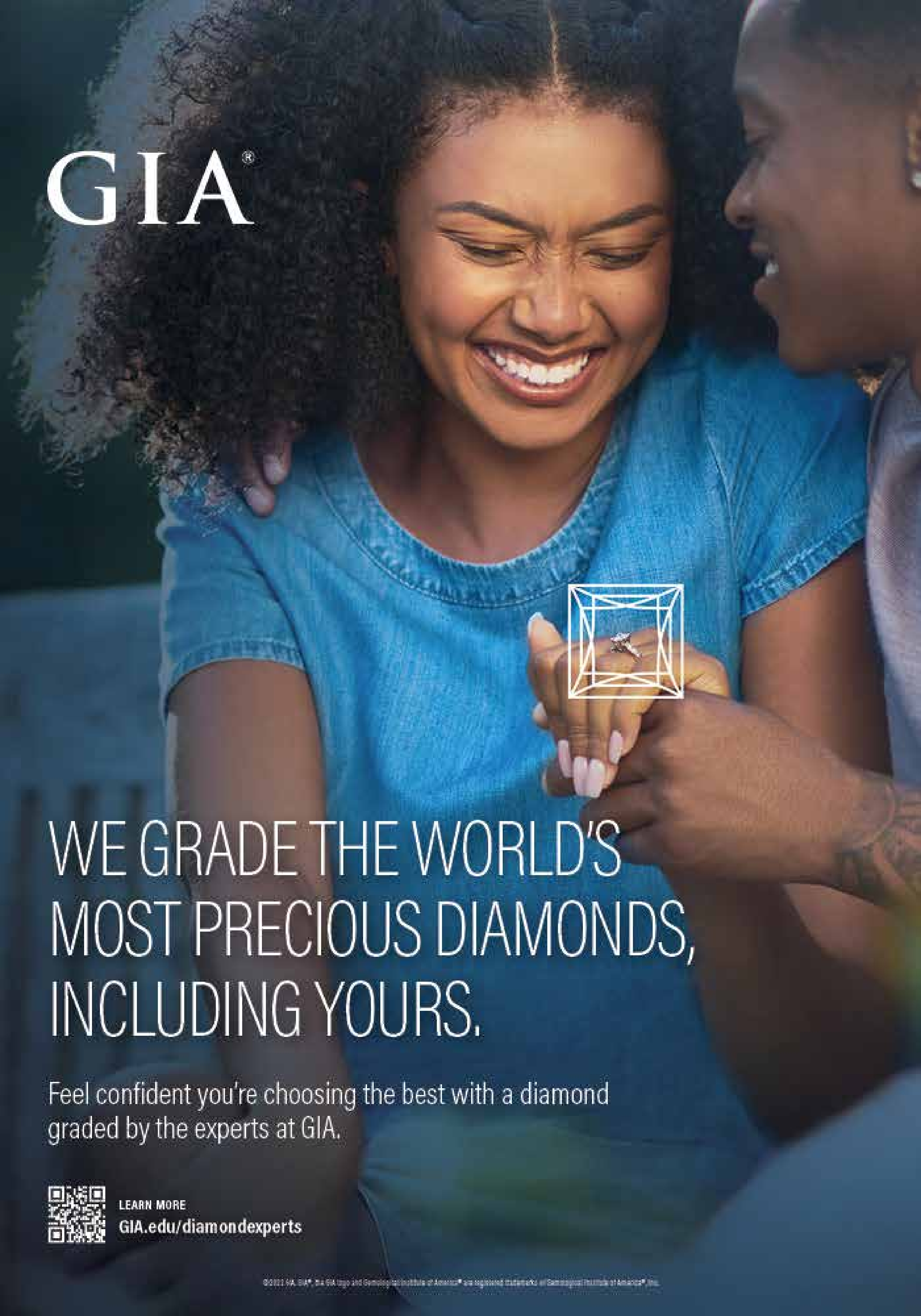
TACY'S 2021
DIAMOND PIPELINE

In US$ billion | Prepared by
Pharos Beam Consulting LLP





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Pandemic was Somehow a BLESSING IN DISGUISE

While on the one hand the reluctance of banks to finance the industry impacted the liquidity situation (and return on capital employed went down), the consumers and downstream in general didn't have to extend suppliers' credit on the same levels as in previous years. Governmental Covid-stimulus packages produces tangible benefits for the jewelry sector.

As the Covid pandemic spread globally, governments reacted by imposing lockdowns and many businesses struggled to operate in those situations. While technology-based businesses could implement a work-from-home policy, service businesses could simply not do that and suffered greatly. To alleviate this issue, governments offered various stimulus packages to keep businesses afloat and help them restart after the lockdowns were relaxed.

The US government offered the most generous stimulus from all governments, and over the course of two years it amounted to nearly 25% of the total GDP for the country. The stimulus was offered in various tranches and covered various different payouts and subsidies by the government. What is equally important from an analysis perspective is the timing of the stimulus. A quick summary of the stimulus packages which were released by the US government is shown in the table.

Package Name	When Passed	Amount ($ billion)
Stimulus and Relief Package 1 & 2	Mar 2020	12
SRP 3 (CARES Act) and 3.5	Mar/Apr 2020	2,724
Lost Wage Assistance	Jul 2020	44
SRP 4	Dec 2020	900
SRP 5 (America Rescue Plan)	Mar 2021	1,900
Total Approved Stimulus		5,580

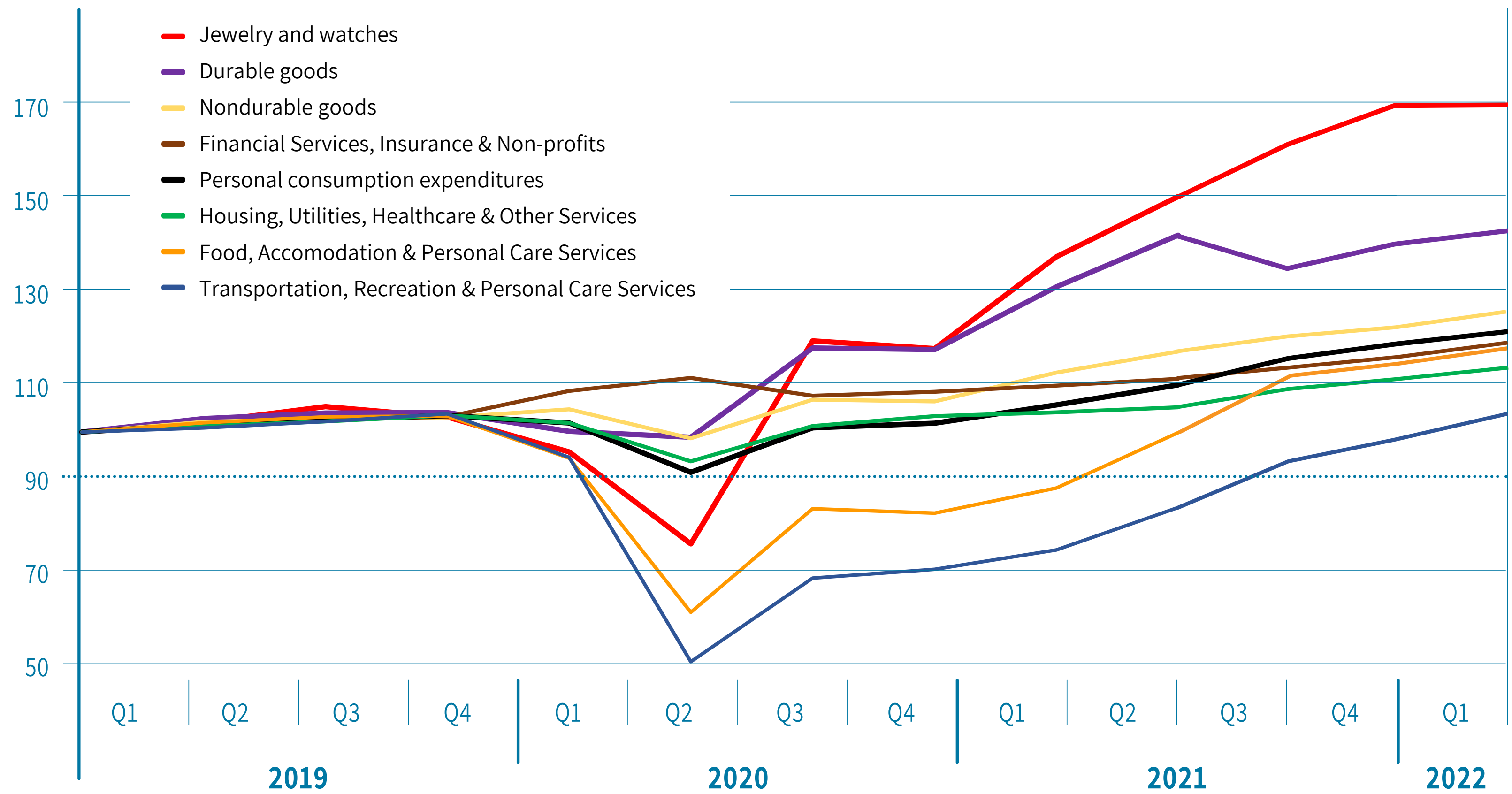
The dates in the table indicate when the stimulus was approved. The amounts were actually spent over a much longer period. The main takeaways are that in real terms more than half of the money actually reached the consumers wallets in 2021. While many citizens did suffer in 2020 and a stimulus was necessary, the continued flow of stimulus in 2021 was the cherry on the cake, leading to the tremendous boost for the US economy.

This boost in spending was uneven and was not felt evenly across all sectors. Certain sectors like services, hospitality and transportation, many of which could also be termed as essential expenses for the consumers, faced severe headwinds as the need for spending on these areas reduced. For example, the continued work-from-home for many top paying tech companies, automatically reduces the fuel bills, need for a vehicle, need for restaurants and cafes, business travel expenses etc.

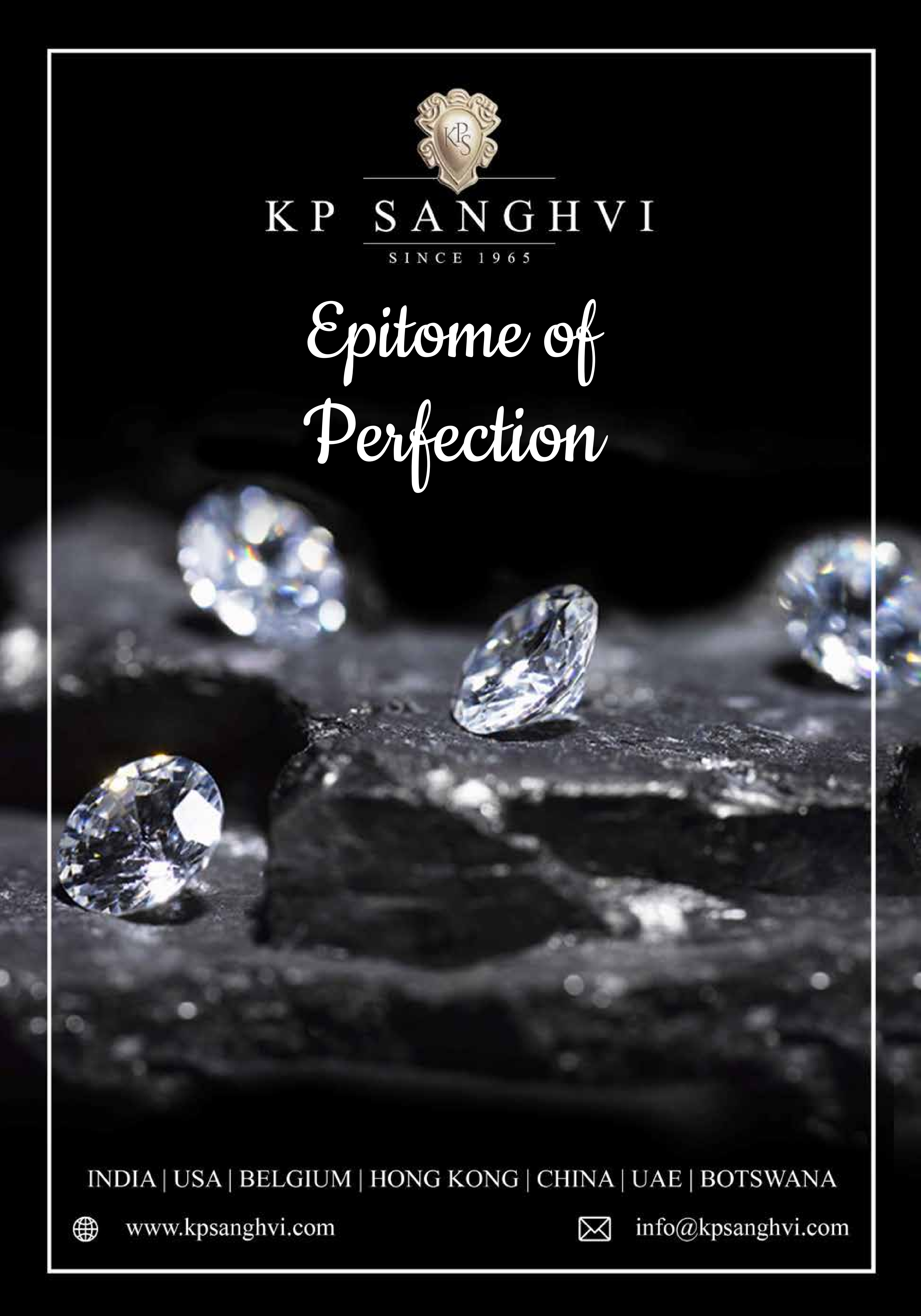
The US consumer has not been big on savings over last few decades but the reduced need for spending along with the stimulus meant that consumers suddenly had extra funds in their pockets. Analysis of the data from the Bureau of Economic Analysis, US Department of Commerce shows the sectors which were the beneficiaries. Durable goods, which includes jewelry, seem to be the biggest gainers, as consumers seem to have channeled their excess disposable incomes into purchasing hard assets which they probably had aspired for, but did not have the income to buy.

Seasonally Adjusted Consumption Expenditure

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



Till the first quarter of 2022, overall Personal Consumption expenditure was up by about 18% compared to the first quarter of 2019, while durable goods were up 43% and jewelry was up by about 70%. Clearly the industry was better placed to garner the aspirational disposable income of consumers. Other luxury sales also saw similar increases in the 50% range in the US, but jewelry was clearly one of the best performing sector.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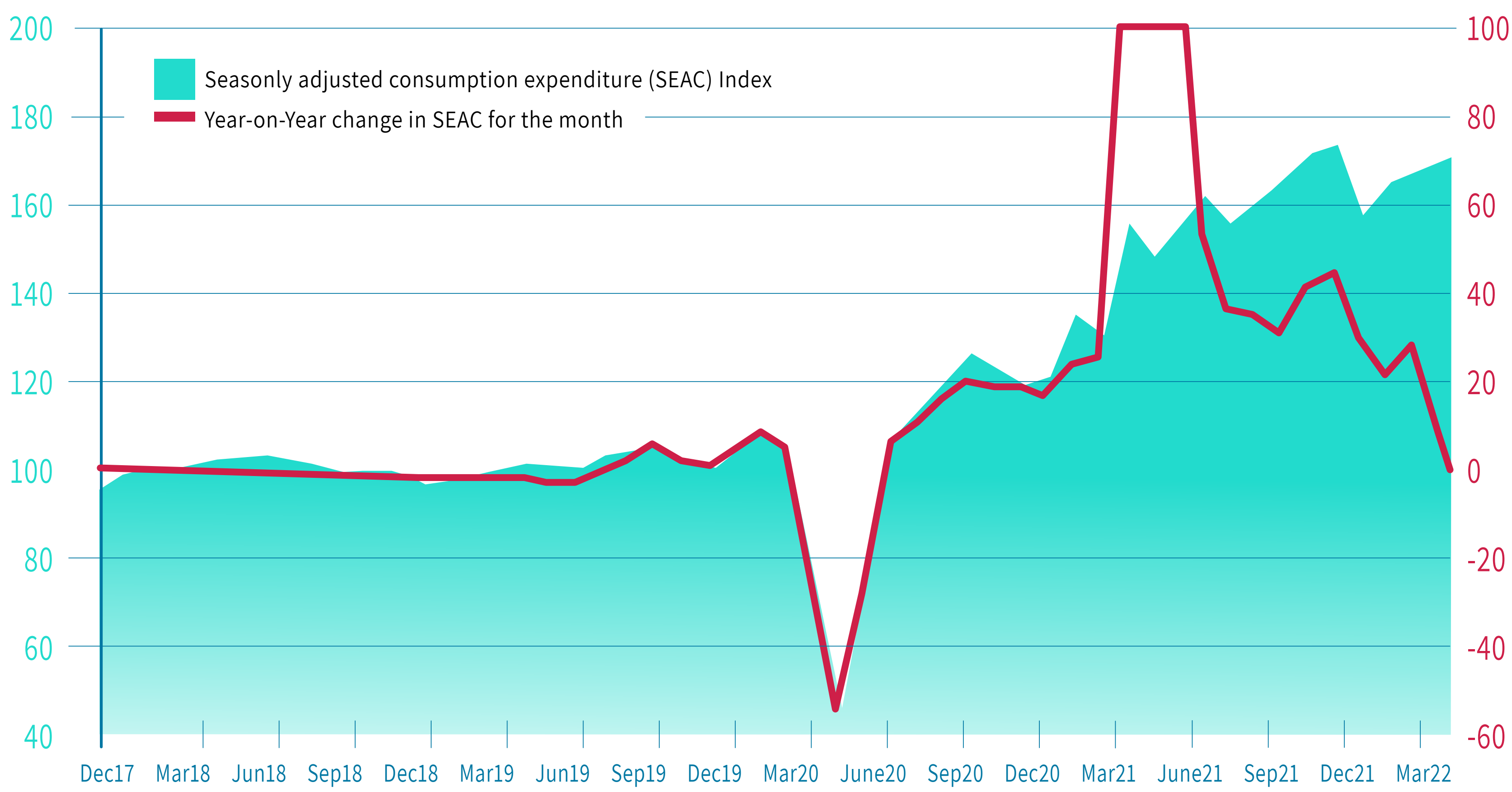
Beware of the MISLEADING HEADLINES

In many news reports, there is generally a reference to year-on-year sales for the month, and in many cases these have made the headlines for their double-digit numbers. However, when sales have shown a large movement, it is important to have a view of both the overall value as well as a YoY view of the sales.

In the first quarter of 2022 many reports showed a double-digit growth rates on a YoY basis, and traders might have been misled into believing that the industry had been growing spectacularly, possibly even fueling some of the speculation which was seen in the first two months of the year.

Seasonally Adjusted Consumption Expenditure

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



Looking at the absolute numbers (the numbers provided by the US Bureau of Economic Analysis are normalized on a month-to-month basis), we can see that the sales have moved in a band post June/July of 2021. In fact, December, which is the peak season for the retail jewelry industry, had the second lowest values in the June to December period.

"The stimulus and the resulting demand had pushed up prices and inflation to levels not seen by the current generation."

Dig deeper and you'll see a rapid increase visible in the January to April period of 2021, probably as consumer confidence increased along with some of the stimulus checks reaching the consumers. This means that even when absolute values remain in the same band for Q1 2022, you will still see high double-digit YoY growth for the month, with a decreasing pattern. The absolute numbers tell us that even if sales were to remain at current levels, you will start seeing low or negative YoY growth from June onwards. Hence it might be prudent for the industry to temper its expectations for the full year.

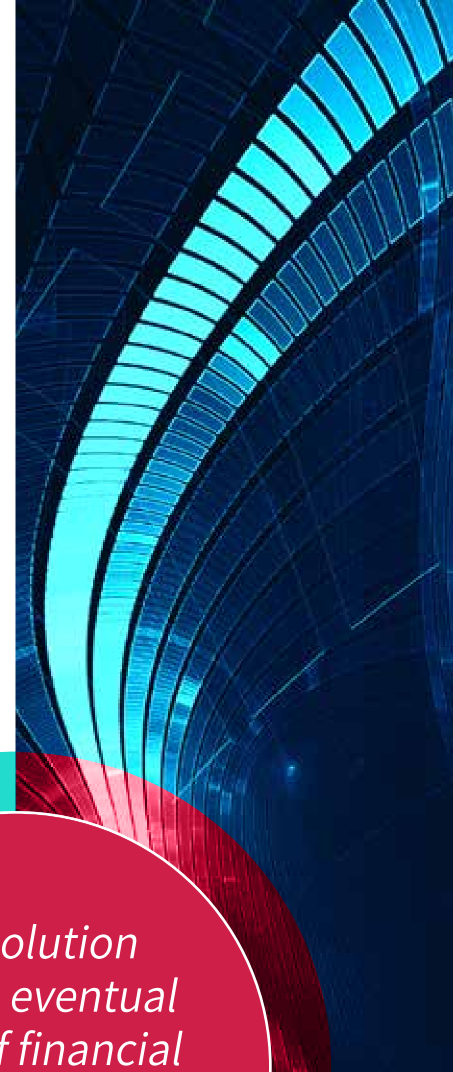
This stimulus money along with the quantitative easing by the central bank and low interest rates, unleashed funds which found their way into investments in the financial sector, which drove up asset prices across the board - housing, stock markets, cryptocurrencies or other assets - which in turn fed into the demand through the wealth effect. Credit card borrowing (the costliest variety) also dropped significantly from the all-time high at the end of 2019 as many paid down their debts.

Time to PAY THE BILLS?

The 2021 party, however, seems to be ending and it may be the time to pay the bills. Most of the stimulus has been paid out and various moratoriums which had been introduced in the US have lapsed. The stimulus and the resulting demand had pushed up prices and inflation to levels not seen by the current generation.

The Federal Reserve has already started to react, though it could be arguably late, to the higher inflation through increased interest rates, and is set to reverse its quantitative easing measures, albeit gradually. Consumer credit card debt has been creeping up and might rival the peak levels by the end of the year.

All this was expected to happen along with the tightening in the labor markets, called by "great resignation" by the media. The rising rates in the US have another knock-on effect, that of strengthening the dollar. In normal circumstances, a strong dollar is a negative factor for growth in the diamond industry.



The financial market situation in 2022, was on the radar for most financial market observers and is not a surprise. It was expected that the diamond industry too would get back to its "normal" state of operations, besieged by the usual problems of low growth and insufficient profitability. Even a best-case scenario for the diamond industry projected a growth of not more than 1-2% for the year at a retail level.

Even considering a flat scenario of a 0% growth implied that the polished sales would drop by about US$ 1 billion and the rough demand would be nearly flat, as the midstream is expected to stock up again. Looking at these projections the speculative frenzy in the markets in the first two months of 2022 was out of place, and expected to correct. All that was before the conflict in Ukraine started.

Russia's Aggression in the Ukraine A GAME CHANGER

"a resolution and the eventual lifting of financial sanctions seems to now be a distant possibility."

The Russian invasion of Ukraine and the resultant actions taken by the western governments could totally upend any business projections or plans which businesses might have budgeted for, especially because of the way our industry is placed, as about 26% of the rough by value and about 32% by volume was supplied by Alrosa, a company majority-owned by the Russian government. It is increasingly clear that Russia is waging attrition warfare, a military strategy of belligerent attempts to win by wearing down the enemy to the point of collapse. This may take many months, if not years – and the belligerence might still expand beyond other borders.

When the war began, the US followed by other European governments, quickly applied financial sanctions on the Russian government. They later included companies like Alrosa, which, they claimed, were financing the Russian war on Ukraine.

The first round of US sanctions prevented Alrosa from doing business in the US, something which was almost negligible and it had almost no impact. The latter round of sanctions saw Alrosa added to the OFAC Specially-Designated Nationals (SDN) list. This sanction is much more damaging because it means that no financial flows can pass through the US. All transactions in the US dollar have to pass through banks in the US and with this inclusion, no bank would be willing to process any payments from customers to Alrosa, thereby throttling the source of income for the country.

When the sanctions were announced, the industry adopted a wait and watch attitude. The speculation in the first couple of months had dulled the mid-stream's appetite for rough and, in a way, the forced absence of supplies from Russia was even considered a blessing in disguise for the industry, which had started to again pile on the stock and debt.

Companies in the industry were hoping for a quick resolution to the conflict and wishing that things would go back to normal. However, hope is not a strategy. As the conflict drags on, the solution seems to be squarely in the realm of politics. Unfortunately, the fate of the conflict will seemingly be determined by people who have very little to lose, which would mean that a resolution and the eventual lifting of financial sanctions seems to now be a distant possibility.

Living with SANCTIONS

Globally the world had been effective uni-polar for over 30 years. Nations across the world are now aware of the damages that financial sanctions can cause and the will of the US to weaponize them. As we go forward, the world will again start becoming multi-polar once again with different countries and blocs trade being primarily restricted to each bloc separately.

In the last decade, financial sanctions have increasingly become the weapon of choice for the US, given its dominant position in the global financial system. Raghuram Rajan, a leading economist, termed financial sanctions as “weapons of mass destruction” due to their blunt nature in trying to effect change.

While sanctions might be inhibitors and have a preventive impact, they have not shown any success in providing immediate solutions once a conflict has started. Countries and citizens may go well beyond their perceived capacities to face sanctions when they feel that they are being unjustly treated. Without going into which side is justified in their view, sanctions can be considered unilateral and gaining their power from the dollar being the primary global currency.

The manner in which governments have gone about applying sanctions also reeks of hypocrisy. Waivers are given by the sanctioning countries to sanctions which are inconvenient or can cause significant upheavals. Waivers have been given on products like oil, natural gas, uranium and titanium where Russia is a major supplier for the nations applying the sanctions. Developing nations have started complaining about the impact of the sanctions on countries that are innocent bystanders.

“sanctions are here to stay and the industry needs to be ready for the long haul, and choose which side to take.”

Another notable aspect of this conflict was how quickly businesses, including jewelry retailers and brands, decided that they would not by Russian-origin diamonds. Brands and retailers have a constant customer interface and probably reacted in this fashion due to their individual political, social or moral compulsions.

These “business sanctions” have further queered the pitch for the industry. Alrosa, in fact, had been at the forefront of promoting industry self-regulation initiatives like the Responsible Jewellery Council and the updated World Diamond Council System of Warranties. It is ironic that now these very same chain of warranty mechanism are being used by the industry to exclude Alrosa.

In future, other countries and companies might not be willing to join such cooperative mechanism, as no country or company can confidently say that it could not be next to face sanctions. Irrespective of how long the sanctions last, it is clear that the industry will find it extremely difficult to come to a common ground or agree on any self-regulation mechanism in the future.

It is clear that for the diamond industry, sanctions are here to stay and the industry needs to be ready for the long haul, and choose which side to take. The sanctions will probably continue even after the conflict stops. One of the primary strengths of the industry is its resilience and the adaptability of its companies, as it has proven again and again over the decades. Reports indicate that Russian rough has already started finding its way to the market.

As our industry adapts to the multi-polar environment, companies clearly need to take sides, having to scale down their business in order for them to continue being compliant. With the current regulations in place, the industry is likely to be split down the middle, with some companies abiding by the sanctions and other companies dealing in Russian diamonds, but not supplying them to the developed world.

We are confident even in a multi-polar world that the industry will continue to adapt and thrive as it has done in the past. Unfortunately sanctions tend to provide the greatest reward to companies that dodge sanctions, at the cost of the responsible companies leading to a fall in the industry compliance standards.

A Matter of COST

The US has been trying for more than a decade to get the diamond industry to segregate its inventories. This was initially proposed for diamonds from Zimbabwe. Various chain of custody initiatives were proposed by the US government agencies to prevent its diamonds being sold in the US. These efforts met with at best partial success. Some diamonds from Zimbabwe were easily identifiable and the volume of supply from the country was limited.

The authors wrote extensively at that point about the segregation of diamonds. The views expressed remain the same even after 10 years, namely:

- Segregation of larger stones (>0.20 carats), which are generally polished individually can be done managed by the industry.
- The challenge is in the smaller diamonds which are traded and sold in parcels with parcels being mixed multiple times.
- It is still feasible to segregate diamonds, however there is a significant cost which would need to be borne by the midstream for maintaining the diamonds separately.
- The authors questioned the ability of the midstream to bear those costs, which were more than US$ 1 billion on an annual basis. Costs had to be passed on to the consumer or borne by the mines.
- It could mean in increase in polished prices of more than 10% in the concerned category of goods.

Our observations in the matter still hold. However with the current emotional support for Ukraine and the general inflationary environment in many developed nations, it might be easier to pass on these costs to the consumers. It is to be seen whether the resolve will remain once the consumer attention moves on to other issues.

A Matter of AVAILABILITY

Apart from the cost perspective, removal of supplies from Alrosa could cause severe availability problems for certain kind of companies. As mentioned, Alrosa diamonds represent about 26% of diamonds by value and about 32% by volume. Clearly their diamonds are smaller with a lower average cost as compared to the market. The impact of the Alrosa sanctions across different categories of diamonds is different, given the production mix of their mines.

Polished which is produced from Alrosa rough, has a much higher share in diamond categories which are used by luxury, lifestyle or high-fashion brands. In many of these categories Alrosa accounts for over 50% of the polished diamonds supplied. Companies in these sectors could face serious issues in obtaining supplies, especially in the latter half of 2022. It is indeed ironic, that many of these luxury brands were some of the first to stop using Russian origin diamonds.

Crossing the RUBICON

Luxury brands take great care in cultivating their image over decades and most big brands have stayed away from using lab grown diamonds in their jewelry or watches. Going forward, with the Alrosa supplies not useable, they could face a supply shock, as there might not be enough diamonds to meet their requirements. The question remains whether they will cross the Rubicon and decide to use LGD in their luxury products, and whether their consumers will accept those products and the spin their marketing teams will give to that decision.

The only segment that would be laughing all the way to the bank would be the LGD industry. Companies have had a phenomenal year, and supply shortages can lead to new business opportunities for LGD jewelry companies, as retailers try and fill their shelves for the season. LGD producers also have not scaled up their capacities to a stage where they can replace Alrosa production, and for a change they might see price increases in the latter half of 2022.

More than the incremental business, the shortages will open new opportunities for LGD suppliers, as companies who would have otherwise not considered selling LGD jewelry are forced to go ahead and keep the product. No wonder the current market conditions might seem like heaven for the LGD industry, while diamond-producing countries continue to lick their wounds.

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