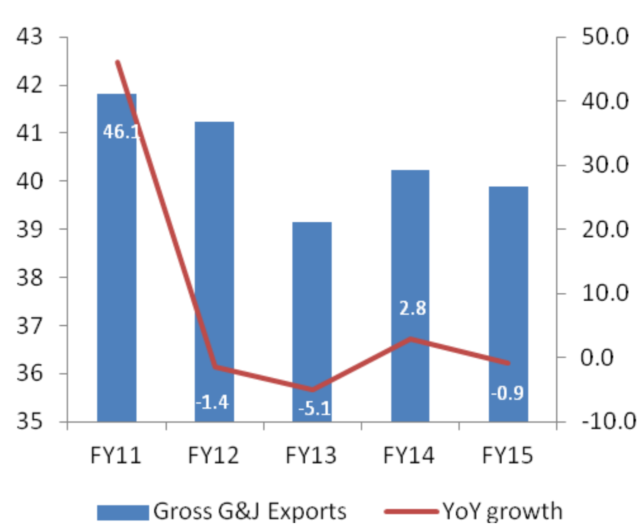
CPD faces headwinds; gold jewellery to gain traction: CARE Ratings

CARE Ratings believes credit profiles of the companies in the cut and polished diamond (CPD) sector in India to moderately deteriorate over medium term on back of sluggish demand in some of the key markets and rein in bank credit. On the other hand, improving availability of gold and consumer sentiments coupled with easing of regulatory restrictions and expansion by organized players is expected to lead to a healthy growth for the gold/ studded jewellery sector in India.

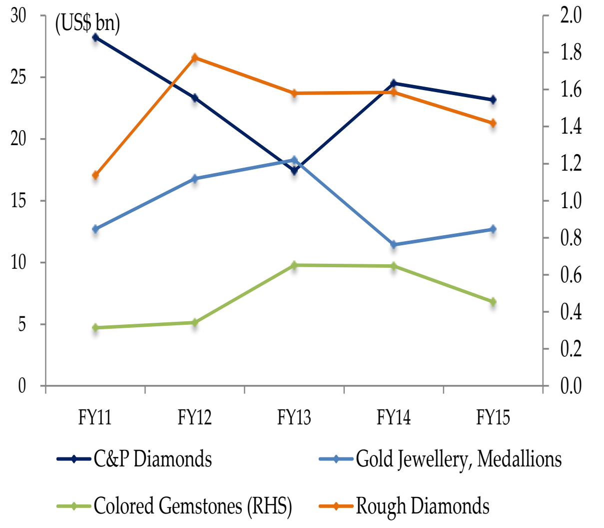
Gems and Jewellery exports marginally down

According to Gems and Jewellery Export Promotion Council (GJEPC), Gem and jewellery (G&J) shipments accounting for nearly 13% of India's overall merchandise export fell marginally by 0.62% in FY15 (refers to the period April 01 to March 31). The overall export of gems & jewellery was reported at US$ 39.89 billion as compared with US$ 40.14 billion for FY14. The marginal decline was on the backdrop of downturn in China, political and terrorist unrest in Middle East, declining European market and the suffering Russian Rouble. During FY15, overall gross export of cut & polished diamond declined by 5.46% y-o-y to US$ 23.16 billion due to lower demand. The export of cut and polished diamonds declined to 345.35 lakh carats in FY15, reporting a decline of 5.64% y-o-y. It continued to decline in April and May 2015 also.

G&J Exports (US$ bn.) and y-o-y growth (%)



Productwise exports



Source:- GJEPC

Rising gold jewellery exports due to regulatory easing

According to GJEPC, export of gold jewellery for FY15 increased to US$ 9.85 billion from US$ 8.36 billion in the previous year, registering significant growth of 17.74% y-o-y; albeit on a lower base. This increase was mainly attributed to improved supply of gold due to regulatory easing in H2FY15 and increase in demand for Indian products from major consuming countries like US, Russia, UAE, Hong Kong and East Asian countries. Export of silver jewellery, too, increased by 39.28% y-o-y to US$ 2.05 billion. To control the increasing trade deficit, the government imposed various measures in FY14 and gradually increased import duty on gold to 10%. As a result, with supply curtailing due to regulatory restrictions and lack of operational clarity on the guidelines, gold jewellery exports declined significantly by about 40% in FY14. Going forward, gold jewellery exports is expected to rise further as raw material supplies have improved after the Reserve Bank of India (RBI) allowed more banks to import bullion and all regulatory restrictions being removed (except for the high import duty).

Domestic gold jewellery demand to rise further; monsoon to be a crucial factor

During CY14 (refers to the period January 01 to December 31), overall domestic demand for gold declined by 13.55% to 842.7 tons as compared with 947.8 tons in the previous year, mainly due to government policies putting restrictions on import of gold which had prevailed for a large part of the year. However, gold jewellery demand was up by 8.06% at 662.1 tons, while total investment demand for gold fell significantly by 50.12% to 180.6 tons in CY14. The increase in domestic demand for gold jewellery was supported by good festival and bridal demand especially during Q4CY14. The traction in gold jewellery continued during Q1CY15 as demand increased by 22% to 150.8 tons compared with 123.5 tons in Q1CY14. The higher growth was mainly on the backdrop of muted demand last year due to stringent gold import policies coupled with weak economic sentiment and trade uncertainty at the time of the general elections. Also, the withdrawal of the 80:20 scheme and lifting the ban on gold on lease provided a fillip to the jewellers during H2FY15.

Indian investment in gold slumped by 50% y-o-y in CY14 to a 5-year low at 180.6 tonnes which is in stark contrast to the record year in jewellery demand in previous year. The drop in investment related demand can be attributed to curb on sale of gold coins and bars, downward bias towards gold price expectations and near-record levels of buying in CY13. Also, investors preferred other alternative asset classes over gold.

(in tons)	CY10	CY11	CY12	CY13	CY14	Q1CY15
Gold Jewellery	657.4	618.3	552.00	612.7	662.1	150.8
Gold Bars & Coin	348.9	368	312.2	362.1	180.6	40.9
Total demand	**1,006.3**	**986.3**	**864.2**	**974.8**	**842.7**	**191.7**

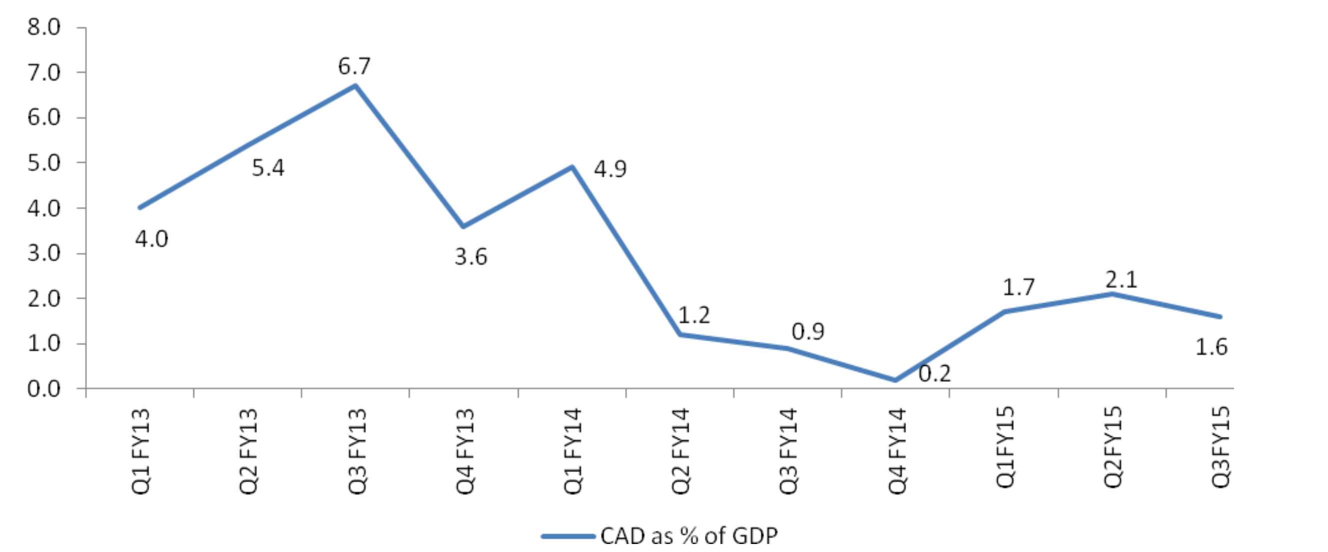
Source: World Gold Council

Going forward, improvement in availability of gold and consumer sentiment coupled with easing of restrictions and expansion of retail network by organized players would lead to 9-11% growth in the gold jewellery demand in the medium term. However, the country's monsoon season will be crucial factor in shaping the domestic demand. The Indian Meteorological Department predicted current season rains to be 88% of long-term average, which would be below the typical 96-104%. However, the rainfall during June 2015 has been in excess than average in most parts of the country. Since India's 120 million farmers account for around 60% of domestic consumption, any impact on agricultural output will have an adverse impact on demand for gold.

Changing regulatory landscape

In order to rein in swelling CAD, government and RBI had implemented various fiscal and monetary measures during FY14 to curtail gold imports. These regulations adversely impacted the Indian G&J industry by increasing the working capital requirements of players, reducing the gold supply in the short term and thereby rising gold prices. However, off late with improvement in CAD situation, government and RBI have slowly started easing of regulations on gold import.

Tapering Current Account Deficit



Source:- RBI

The CAD significantly contracted to 0.2% of the GDP in Q4FY14 on account of plunge in imports due to gold import restrictions. However, CAD has narrowed to 1.7% during 9MFY15 due to lower oil prices and higher services exports that offset the dip in merchandise shipments. Government of India has proposed *'Gold Monetisation Scheme'* with objective of mobilizing huge gold reserves held by households and institutions, viz, banks, temples and other similar institutions in the country, to provide a boost to the gems and jewellery sector by making gold available as raw material on loan from the banks and to reduce reliance on import of gold over time to meet the domestic demand.

However the success of proposed scheme is dependent on following factors:

- Willingness to part with gold jewellery by Indian people due to high degree of emotional value.
- Process of purification, testing and assaying of gold would be cumbersome
- Attractiveness of interest rates offered by banks.
- Lock-in period and redemption option available to the depositors.
- Availability of Tax Exemptions
- Non-availability of ownership documentation, as most household gold would be inter-generational and archaic.
- Permission to banks to deposit the mobilized gold as part of their CRR/SLR requirements with RBI.

The table below shows the timelines and amendments of guidelines by RBI and Government for gold imports:

Regulatory Restriction Imposed during High CAD period		Regulatory Restriction Easing, as CAD declined	
May 13, 2013	RBI **restricted the import of gold** on consignment basis to only exporters of gold jewellery.	**May 21, 2014**	**RBI allowed Trading Houses** registered as nominated agencies by the Director General of Foreign Trade (DGFT) to import gold under 20:80 scheme.
June 4, 2013	The Government **increased the import duty** on gold and platinum from 6% to 8%.		**Gold on lease scheme allowed by the RBI** to domestic jewellery manufacturer.
	RBI directed that all Letters of Credit (LC) to be opened by Nominated Banks/Agencies for the import of gold under all categories will be only on 100% cash margin basis.	**Nov 28, 2014**	**RBI scrapped 80:20 scheme.**
July 22, 2013	**RBI Introduced 20/80 scheme.**	**Feb 18, 2015**	**RBI lifts ban on import of gold coins**, medallions by banks & trading houses.
	RBI asked banks and credit card companies to discontinue the EMI option for online jewellery purchase.		
Aug 13, 2013	**The Government increased the import duty on gold and platinum from 8% to 10%.**		
Aug 14, 2013	**RBI again prohibited Gold-on-lease** after withdrawing the ban in July 2013.		
	Prohibition of imports of gold coins and medallions.		
	Furthermore, it was directed that gold will be made available to only jewellers/bullion dealers/banks involved in gold deposit scheme after upfront payment of cash.		
Sept 18, 2013	The Government increased the import duty on gold jewellery from 10% to 15%.		

Tepid profitability performance of the CPD players; gold jewellers shine

Over the past few years, the diamond processing players have witnessed margin pressures on back of increase in rough diamond prices without proportionate increase in polished diamond prices. An analysis for sample of CARE rated CPD players suggests that PBILDT margins have reduced by approximately 50-55 bps between FY12 to FY14. It was about 5.9% in FY14 and expected to be slightly sluggish in FY15. It may be noted that exports still continue to remain weak as buyers are concerned about the growth in the global economy and an impending rate increase by the US Federal Reserve. For the period, April-May 2015, the GJ exports declined by 8.39% y-o-y, while C&P diamond exports declined by 10.17%

On the other hand, during FY14, regulatory impositions along with volatile operating scenario had an adverse impact on the revenues and earnings of the gold jewellery players. The domestic gold jewellery players saw a significant rise in interest cost on account of shift in funding towards cash credit facility as opposed to traditional gold loan funding. Also, margins of gold jewellery players were under pressure for early part of FY15 on account of regulatory restrictions and tightening of credit. However, the withdrawal of the 80:20 scheme and lifting ban on gold on lease provided a fillip to the players during H2FY15. The PBILDT margins for these players expanded 130 bps during FY12 to FY15.

Impact on the Credit profiles

CARE Ratings believes that amongst its rated players in the G&J sector, credit risk profiles of the cut and polished diamonds players is expected to moderately weaken in medium term on back of sluggish export demand, downward pressure on margins and rein in bank credit. While the credit risk profiles of gold/ studded jewellery players are expected to remain largely stable with easing of regulations, lower finance cost and improvement in domestic demand sentiment.

Of the CARE rated G&J companies, 55% are in investment grade category (in 'BBB' and ‘A’ category; as seen in the table below, considering long-term rating) due to factors such as relatively stable performance metrics and moderate liquidity profile. During FY15, the credit profile of CARE rated G&J companies has broadly remained stable.

Credit Profile of CARE rated G & J Players

Long term rating	% of Total rated firms
A	16%
BBB	39%
BB	34%
B	10%
D	1%
Total companies (LT rating)	**128**

Source:- CARE Rating

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