Gems and Jewellery Update

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Overview

The Gems and Jewellery industry is an important sector with a high contribution to India's merchandise exports and employment generation. It has however been impacted by a tough business environment and tepid domestic demand during the first quarter of FY19.

In FY18, Indian gold demand met primarily through imports increased due to jewellers' restocking inventory and enhanced retail interest. However, for the first four months of FY19 a lower than anticipated demand and a depreciating rupee have hindered imports.

Gold prices were volatile in FY18 and have been on a general downward trend and are anticipated to remain weak due to factors such as trade disputes, strong US dollar and a hike in the interest rates by the US Federal Reserve.

In CY17, global diamond jewellery consumer demand reached $83bn from $62 bn in CY10, growing at a CAGR of 4% driven by sustained growth in the US and increased demand in China

For the first four months of FY19, overall exports stood at $10.6 bn, a decline of 4% compared with $11.1 bn during the same period last year. The growth in cut and polished diamonds, and gold jewellery was suppressed by the drop in silver jewellery and gold medallions exports which negatively affected overall growth. For the Apr –Jul FY19 period, overall imports witnessed a decline of 4% to $10.3bn. UAE, US, and Hong Kong continue to be the biggest trading partners of the Indian gems and jewellery sector.

As a part of measures to control the current account deficit, the government increased the basic customs duty of certain items such as cut & polished diamonds and synthetic diamonds, but has not imposed any additional duty on gold.

Credit exposure to the sector is depressed especially to the diamond segment. However, according to market participants; credit availability has eased for only the higher rated jewellery players.

Gold

Chart 1: Global Gold demand

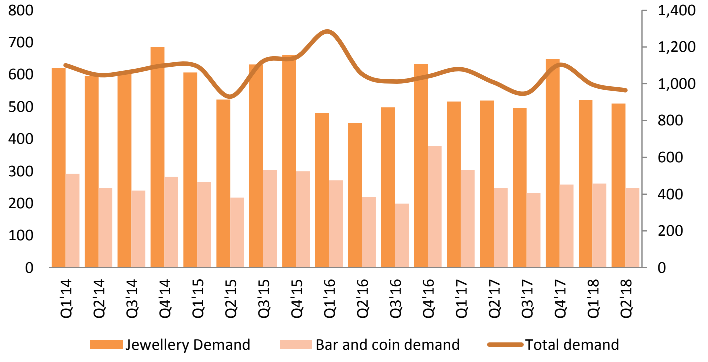
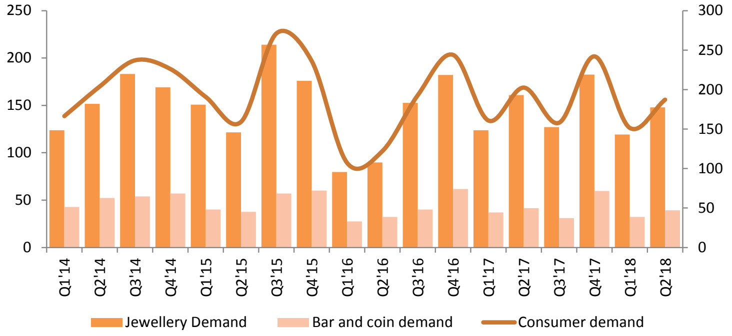


Chart 2: Domestic Gold demand

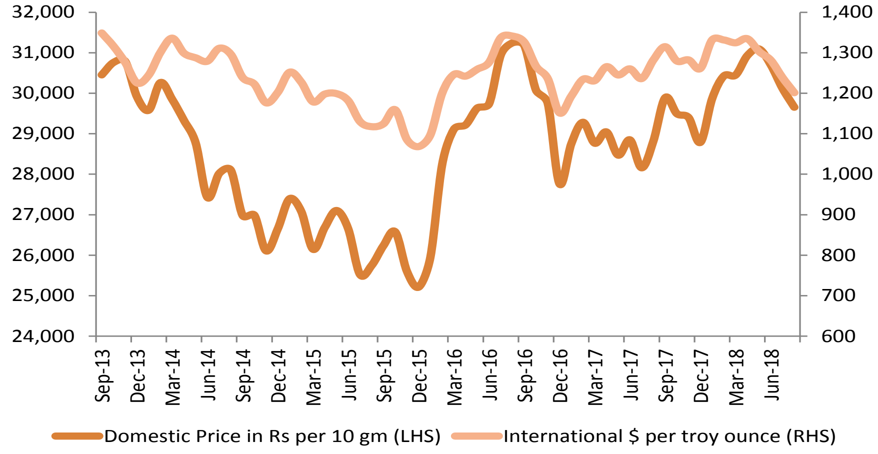


Source: CMIE, World Gold Council

In FY18, gold imports reached $33.7bn, an increase of over 20% compared with FY17. According to RBI, gold imports reached 955.2 tonnes as jewellers' replenished inventory amidst a turnaround in retail demand after demonetisation in the preceding year. For the first four months of FY19, gold imports fell to 334.4 tonnes compared with 380 tonnes in the preceding financial year. Lower demand and a depreciating rupee have affected imports. However, gold demand is anticipated to increase due to an anticipated improvement in rural incomes buying power and the arrival of the primary festival season (Diwali and Dussehra) and the wedding season. Additionally, RBI announced the purchase of 2.5 tonnes of gold in March, following a smaller purchase of 0.3 tonnes in December 2017. These increases in gold reserves are the first since November 2009, when the RBI purchased 200 tonnes from the IMF.

Gold Prices

Chart 3: Average Monthly Gold Price: Domestic and International



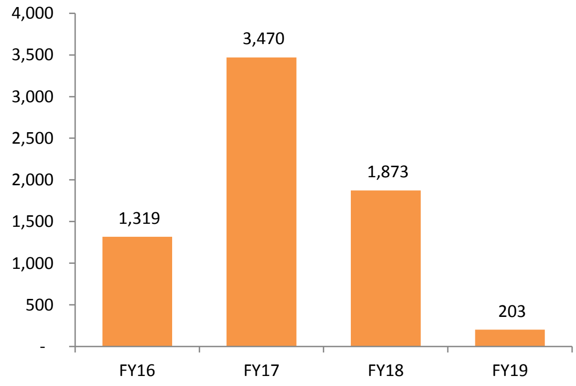
Source: CMIE, World Gold Council

Gold prices have remained volatile in FY18 and have moved in a narrow band (up 2.5% and down 1.5%), with a high of $1,358.46 and a low of $1,212.46. Gold prices have been falling in FY19 both internationally and domestically, (in spite of a falling rupee). Gold has dropped primarily on account of the trade dispute between US and China. Further, this dispute has also created a safe haven demand of the dollar which has also contributed to the fall in gold prices. A seasonal drop in demand from local jewellers and retailers has also increased the pressure on gold prices. Additionally, a stronger dollar has also driven the divergence between US$ gold price and domestic price.

In the short term, gold prices are expected to trend downwards as the US Federal Reserve has raised the benchmark rates and has provided a guide for future increases. This has increased bond yields and generally strengthened the dollar demand and depressed gold prices. In the medium term, geo-political tensions in the Middle East, trade disputes with China, increasing US government debt and rising inflation pressures, volatility and lower equity markets could support gold prices. A weaker rupee, costlier imports, lower demand, GST issues and a preference for alternative investment avenues such as the equity markets have continued to hamper domestic gold prices.

Progress of Sovereign Gold Bonds

Chart 4: Sovereign Gold Bolds (in Rs. Cr.)

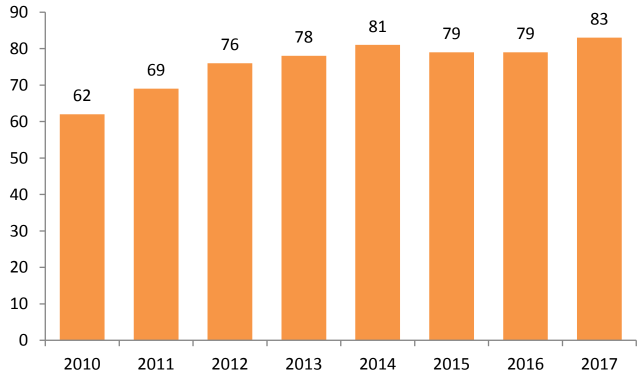


Note: FY19 data till June 2018
Source: RBI

The current gold monetization scheme has had limited success, with only Rs 68.96 billion (23.5 tonnes) being raised since its inception until June 30, 2018. This compares unfavourably with Turkey, which has been able to bring 3-4% of private gold into circulation. To successfully implement the scheme, the government would have to incentivise banks to hold gold deposits and offer domestic consumers a higher rate of interest and a certain leeway from tax scrutiny while depositing gold in the banks.

Global Diamond Jewellery

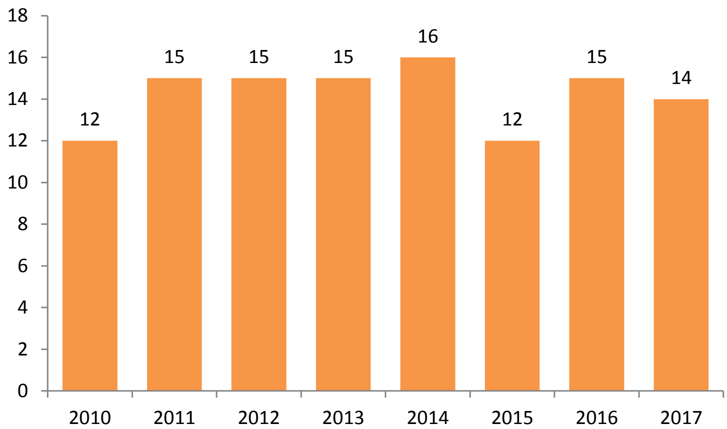
Chart 5: Global Diamond Jewellery Sales (in $ bn)



Source: Alrosa presentation

Global consumer demand for diamond jewellery reached $83bn in CY2017, growing at a CAGR of 4% from $62 bn in CY2010 driven by sustained growth in the US and increased demand in China. However demand for diamond jewellery in other main markets such as India witnessed a decline. The CY2018 global outlook is positive primarily due to consumer sentiment and a sustained marketing and brand building investment by the diamond companies. In India, inflation, higher interest rates and a weakening rupee could negatively impact consumer demand. We expect only larger organised retailer chains to grow at the expense of the smaller unorganised retailers.

Chart 6: Global Estimated Rough Diamond Sales (in $ bn)

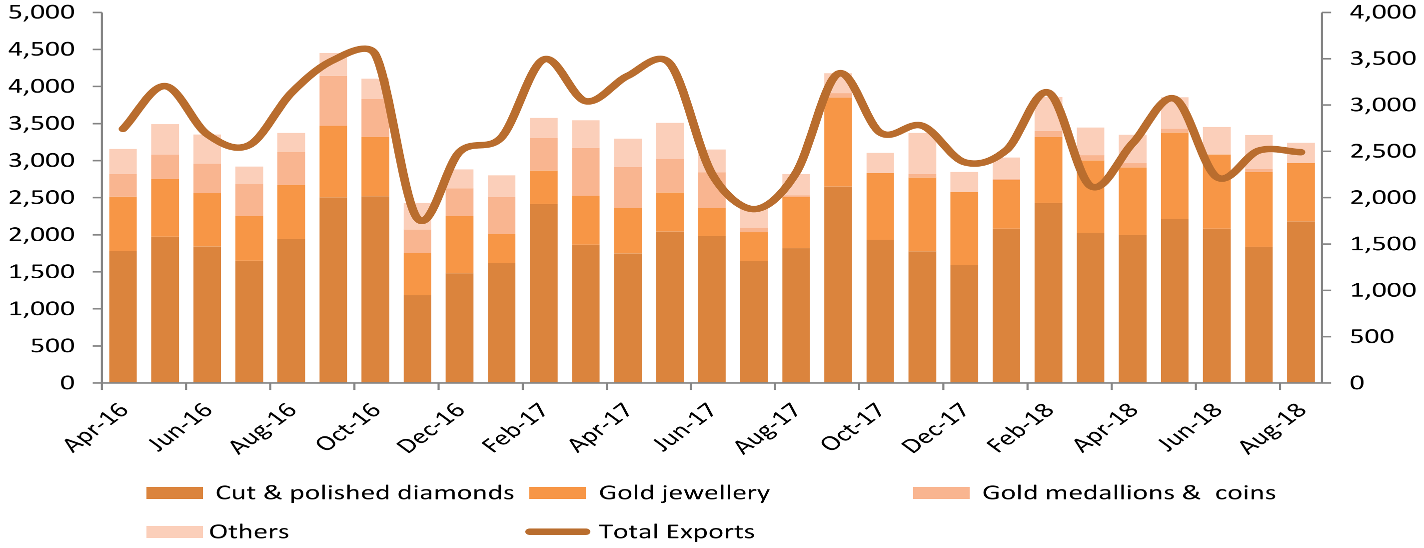


Source: Alrosa presentation

In CY2017, the global rough diamond production increased by 14% to 164 million carats. Russia remained the largest country both in carat as well as value terms. De Beers Group with a 34% share continued to remain the largest supplier of rough diamonds, followed by ALROSA and Rio Tinto. According to De Beers, the total diamond production in CY2018 is expected to reduce marginally as compared to CY2017.

Trade

Chart 7: Gems and Jewellery Exports (in $ mn)



Source: CMIE

FY18 exports stood at $32.7bn registering a drop of 7.9% over FY17. For the first five months of FY19, exports stood at $13.2 bn, a decline of 0.9% compared with $13.3 bn during the same period last year.

- Gross cut and polished diamonds exports reached $10.3bn in the Apr- Aug period of FY19 registering a growth of 11.5% over $9.2bn in the similar period of FY18. Gross gold jewellery exports also nearly doubled its growth to $5.1bn in the Apr- Aug period of FY19 compared with FY18.
- The substantial increase in exports above was offset as silver jewellery exports sharply reduced to $0.2bn, compared with $2.0bn last year. Further, Gold medallion exports also paralleled the drop by reducing to $0.2bn compared to $1.6bn in the Apr- Aug period of FY18. The drop can be primarily accounted by the government not permitting the export of gold medallions and other articles above 22-carat purity to arrest round tripping.

Chart 8: YTDFY19 Diamond exports by country

(In carats) **(In Rs mn)**

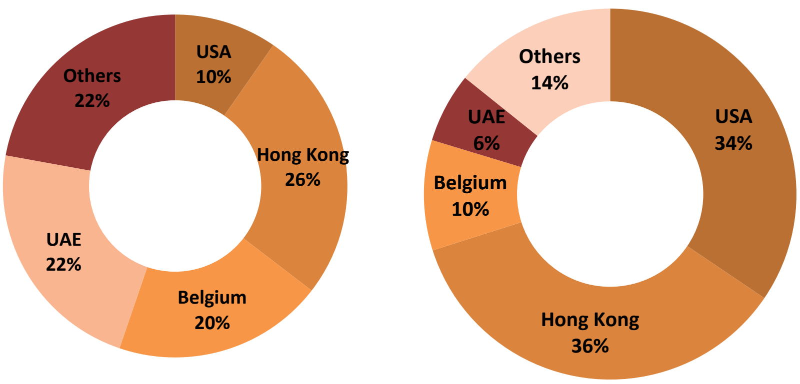
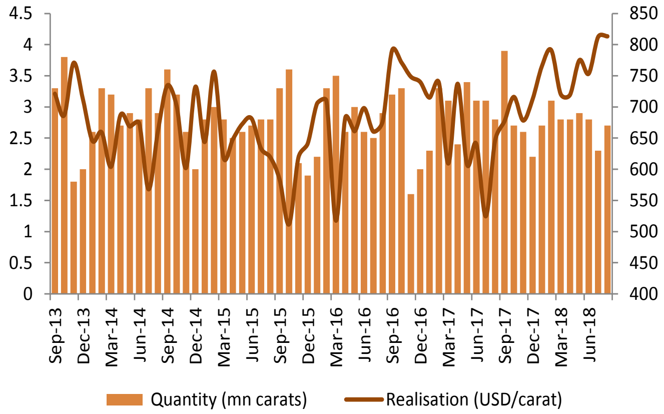


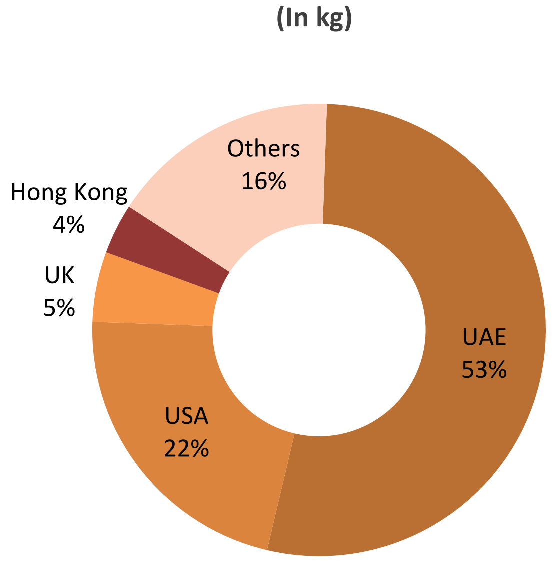
Chart 9: C&P Diamond exports

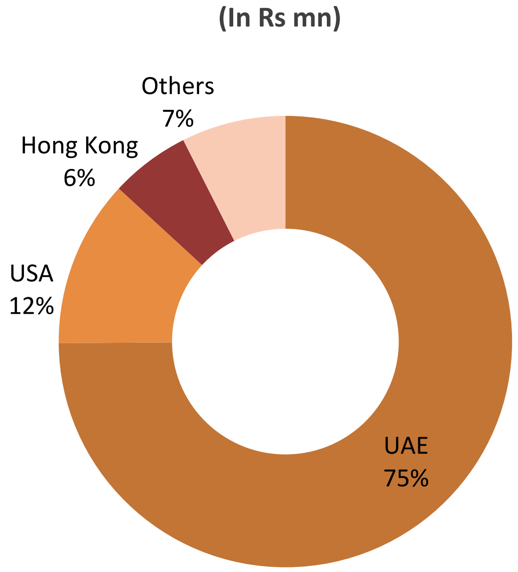


YTD: Apr- July
Source: CMIE

In the first four months of FY19, the largest diamond export destination was Hong Kong with a 26% share by volume and 36% share by value. Also it is noticeable that USA which has a low volume share of 10% has a higher value share of 34%, while UAE exhibits the reverse trend with a higher volume share of 22% and a lower value share of 6%. This can be attributed to the USA receiving higher value stones and therefore better realisations and UAE offering better volumes.

Chart 10: YTDFY19 Gold Jewellery exports by country

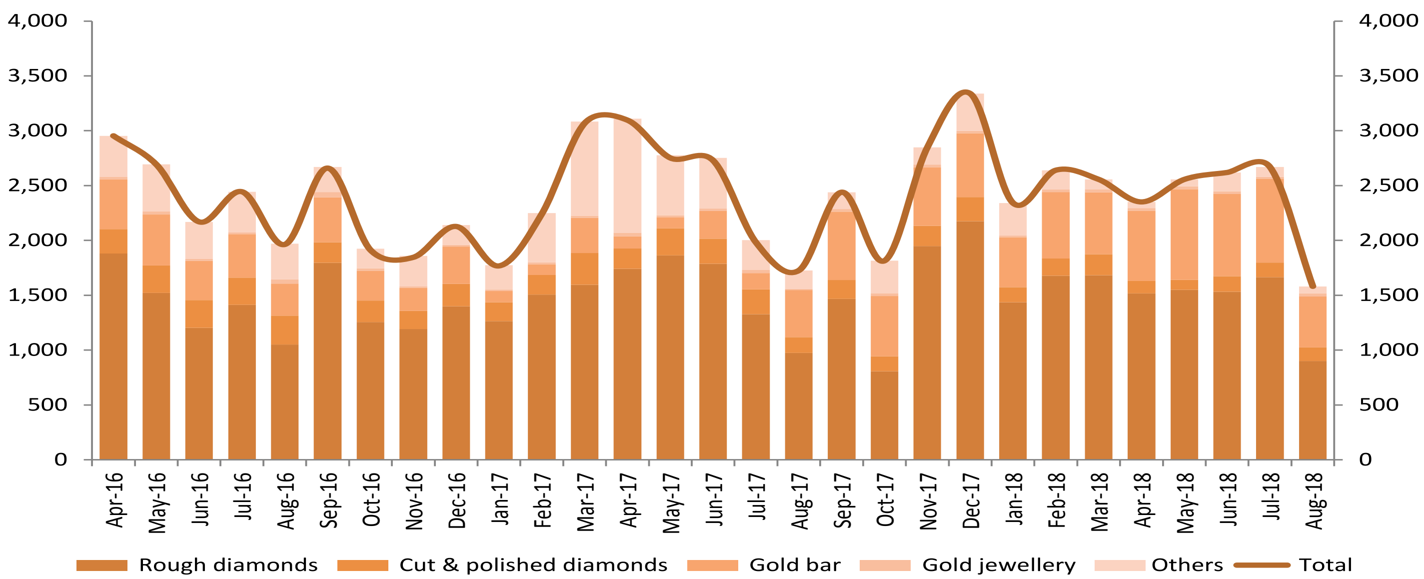




YTD: Apr- July
Source: CMIE

In the first four months of FY19, the largest gold jewellery export destination was UAE with a 53% share by volume and 75% share by value. USA is the second largest destination by both volume and value.

Chart 11: Gems and Jewellery Imports (in $ mn)

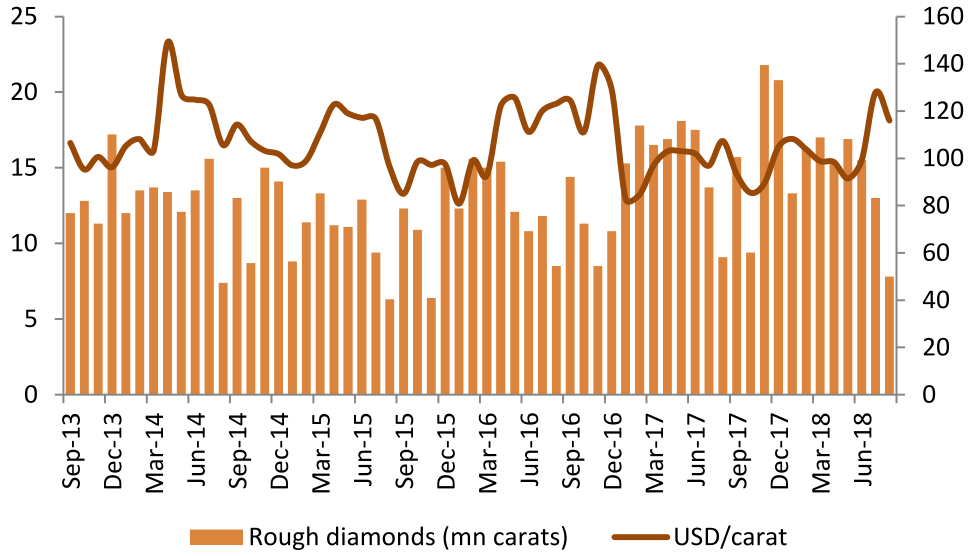


Source: CMIE

In FY18, imports reached $31.5bn and growth slowed to 9.7% compared with 18.6% in FY17. For the first five months of FY19, overall gem and jewellery imports witnessed a decline of 4.5% to $11.9bn from $12.5 bn in first five months of FY18.

In FY18, rough diamonds imports increased by 10.6% to reach $18.9bn from $17bn in FY17. One reason for the increase has been the anticipated price increase by international diamond companies. Imports of gold bar were up 34% to $5.7bn from $4.2bn in FY17. On the other hand, import of cut & polished diamonds declined by 15.1% to reach $2.2bn in FY18 from $2.6bn in FY17.

Chart 12: Rough Diamond Imports



Source: CMIE

Rough diamond imports for the Apr- Aug period of FY19 fell by 7.2% to reach $7.1bn from $7.7bn during the same period last year. Rough diamond volumes also declined by 8.9% to 68.6 million carats from 75.3 million carats in same period last year. Consequently, average per carat realisations improved from $102.2 last year to $104.2 for the Apr- Aug period of FY19. Cut & polished diamonds also witnessed a steep fall from $1 bn in the Apr- Aug period of FY18 to $0.6 bn in the current year. However, this sharp drop was mitigated by the significant increase in the import of gold bars from $1.3bn last year to $3.6bn in the current year.

Recent Developments

- **Increase in Import duty:** As a part of the CAD reduction measures, the government increased the basic customs duty of the items in the table below, but has not imposed any additional duty on gold.

Item	Basic customs duty (%)	
	From	To
Non industrial diamond (other than rough diamonds), i.e., cut and polished diamond	5	7.5
Diamonds-semi processed, half cut or broken	5	7.5
Lab grown diamonds	5	7.5
Cut and polished Coloured gemstone	5	7.5
Articles of jewellery and parts thereof, of precious metal or of metal clad with precious metal	15	20
Articles of Goldsmith or silversmith wares and parts thereof of precious metal or of metal clad with precious metal	15	20

Imports of cut and polished diamonds and gemstones although high in earlier years, has been generally on a downtrend. Further, synthetic diamonds constitute a small portion of the industry. Consequently, there would not be a material impact on the diamond portion of the industry. However, it should be noted that exporters of jewellery who were importing cut and polished diamonds may witness cost escalation which they would not be able to pass fully on their customers thereby impacting margins. Further, this tariff hike would not impact those importers who are sourcing from countries which have an FTA with India.

Import of jewellery and finished products had increased significantly in FY18, however, this trend has not continued for the first four months of FY19, which have witnessed a decrease in imports. Further, with a clear demarcation of duty imposition on finished jewellery products, it is apparent that the government is promoting value added domestic manufacturing. A few unique imported jewellery items may witness a marginal price increase bur demand reduction is not anticipated as this small segment is not price-sensitive.

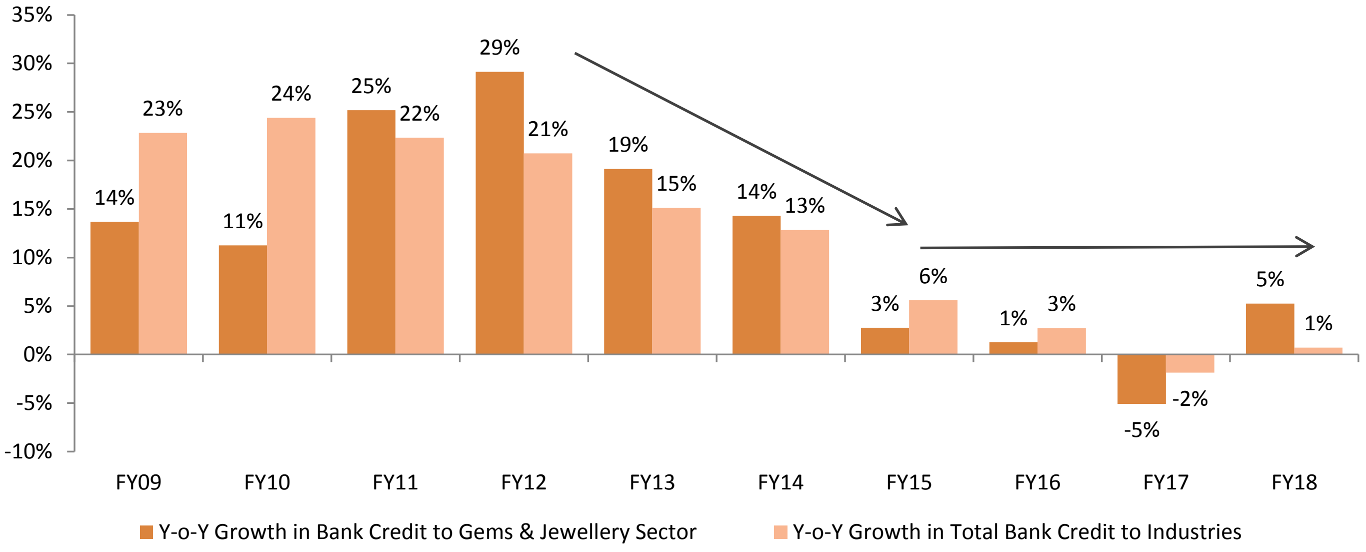
Other Developments

- The Government of India is planning to set up a Common Facility Center (CFC) at Thrissur, Kerala.
- West Bengal government has reportedly allotted land of approximately 25,000 sq ft in size for a gem and jewellery park at Ankurhati, Domjur to Gem & Jewellery Export Promotion Council (GJEPC)
- GJEPC has signed a MoU with MIDC for setting up a 25 acre Jewellery Park in Mumbai.
- The Bureau of Indian Standards (BIS) has revised gold hallmarking standard. The hallmark would include a BIS mark, purity in carat and fitness, unit's identification and the jeweller's identification mark.
- Indian jewellery design and manufacturing firm Renaissance has acquired US based Jay Gems for about Rs 200 crore. The deal would allow Renaissance access to the Enchanted jewellery collection of the Disney Fine Jewellery, which has an exclusive licensing agreement with Jay Gems.
- Warburg Pincus-backed Kalyan Jewellers is planning to file draft papers for initial public offering (IPO) to raise around Rs 2,500 crore
- PN Gadgil has filed a DRHP to raise around Rs 500 crore

Credit exposure

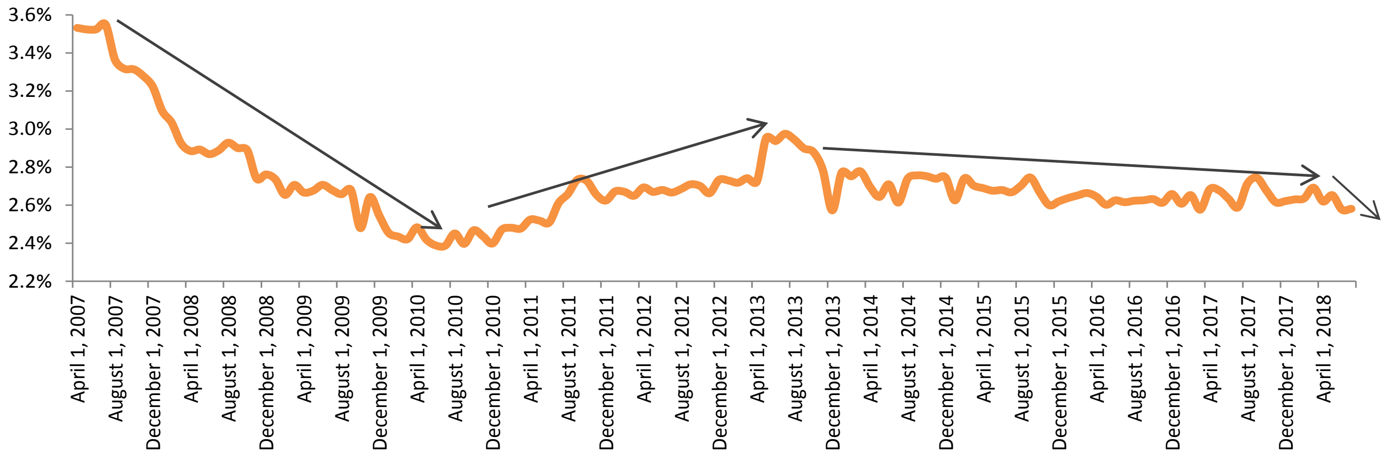
Share of gems & jewellery sector in the total credit exposure of banks to industries has been in the range of 2.5% to 3%. The share of exposure dipped in 2009 and 2010 post the global financial crisis in 2008. However post 2011 the credit exposure of banks to the sector picked up; with y-o-y growth in bank credit exposure the sector continuing to be higher than the y-o-y growth in overall bank credit to industries till FY14. In FY15 - FY17, the share of gems & jewellery sector exhibited a dip. This was on the back of overall glut in the polished diamond market globally. At the end of FY18, there was again an improvement in bank's exposure to gems & jewellery sector, which was at Rs.727 billion as against Rs.690 billion at the end of FY17. However, this improvement is only a move back to the FY16 level. In FY19, due to Nirav Modi's alleged financial irregularities, bank credit especially to the diamond segment has reduced and is expected to remain depressed. However, there are reports that banks are currently lending to organized gold jewellery companies who are expected to gain greater market share with implementation of GST.

Chart 13: Trend in Growth in Credit Exposure of Banks to Gems & Jewellery Sector vis-à-vis Other Industries:



Source: RBI

Chart 14: Trend in Share of Gems & Jewellery Sector in Total Outstanding Bank Credit to Industries



Source: RBI

Financials

Chart 15: Margins

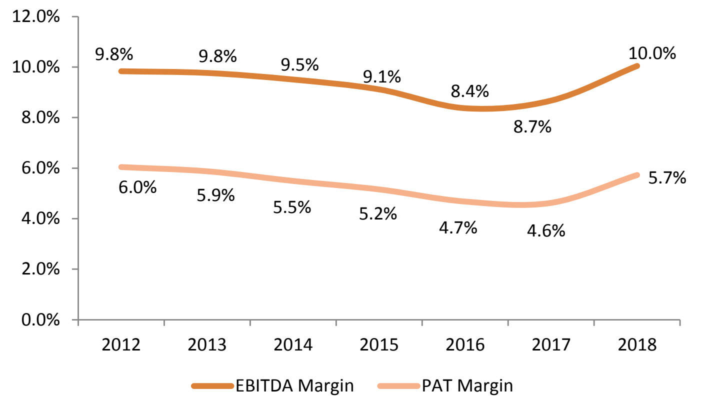
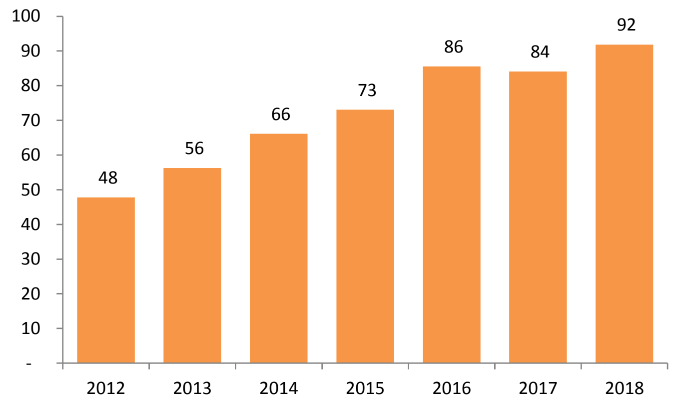


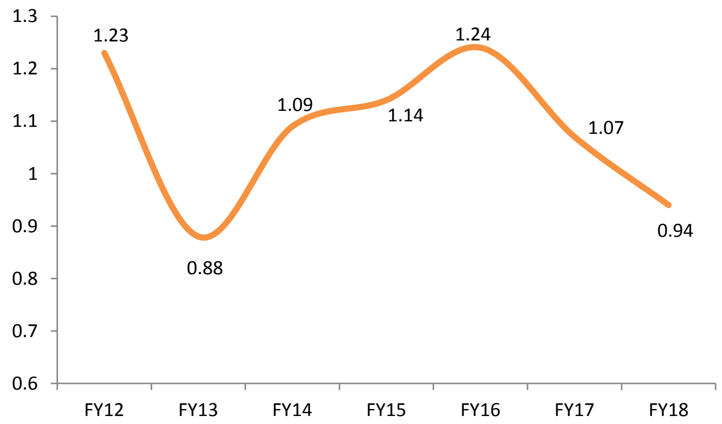
Chart 16: Days Working Capital



Note: List of companies: Asian Star Co, Goldiam Internatl., Golkunda Diamonds, Kanani Industries, PC Jeweller, Pure Giftcarat, Renaissance Jewell, Shantivijay Jewels, Thangamayil Jeweller, Titan Co, Tribhovandas Bhimji and Vaibhav Global
Source: Ace Equity

Net sales of the abovementioned 12 companies grew and margins expanded in FY18 due to an improvement in product mix and higher sales of studded jewellery along with cost control. However, GST refunds and increasing working capital requirements have tempered numbers to some extent. A relatively long operating cycle and working capital intensive nature of business is an inherent characteristic of the G&J industry. However, the operating cycle increased from 48 days at end-FY12 to 92 days at end-FY18 primarily on account of a higher collection period and higher inventory. This affects liquidity and results in higher utilisation of bank credit.

Chart 17: MCR[1] Movement for the Gems and Jewellery sector



Source: CARE Ratings

The changes in credit rating of the rated entities reflect improvement, stability or weakness in the financial health of these entities. These changes are captured in CARE Ratings' Modified Credit Ratio (MCR), and an increase in MCR denotes an increase in upgrades vis-à-vis downgrades, whereas a decrease in MCR shows the reverse. The MCR for Gems and Jewellery segment witnessed a decline due to weakening in credit quality and worsening of liquidity position for companies operating in the diamond segment of the Gems and Jewellery industry.

[1] CARE Ratings' Modified Credit Ratio (MCR) is defined as the ratio of (upgrades and reaffirmations) to (downgrades and reaffirmations)

Outlook

- The overall domestic gems & jewellery demand is expected to remain tepid for FY19, although the second half is expected to be better than the first half due to factors including 1) safe haven appeal of gold due to volatility in equity markets, 2) decent rainfall, 3) several festivals and 4) the wedding season.
- Branding would continue to gain significance. Share of national and regional organized jewellery retailers is expected to grow.
- CARE Ratings believes the pressure on the profit margins for cut & polished diamond players would continue, as globally supply of rough diamonds is expected to continue to remain tight going ahead which could increase rough diamond prices and slowing funding lines from banks.

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