Rating Methodology: Cut and Polished Diamond Industry

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Industry overview

Since its emergence in the 1970s, India's market share in Cut and Polished diamonds has been growing steadily and the country contributes 60% of the world's supply in terms of value, 85% in terms of volume, and 92% in terms of pieces. Lower labour costs, operational efficiency, and the capability to adapt to new technologies are factors that have made India a global leader in cutting and polishing of not only small diamonds but also larger carat stones. Most players are concentrated in two cities of Gujarat – Surat and Navsari.

The Indian cut and polished diamond (CPD) industry contributes around 53% to the overall gems and jewellery exports from India and contributes a significant portion to the gross domestic product (GDP), net foreign exchange earnings (FEEs), and employment of the country. Majority of diamonds polished in India are exported to key diamond jewellery manufacturing centres and jewellery retailers based in Hong Kong, China, and the US. The industry is largely fragmented and unorganised, with intense competition, thin profitability, and high working capital intensity.

There are a series of processes that rough diamonds pass through before being sold in the retail market. The diamond jewellery value chain begins with the mining of rough diamonds, moves to processing through cutting and polishing to manufacture cut and polished diamonds, and then comes the manufacturing of jewellery, followed by retail sales across the globe for end consumption. The Indian CPD industry plays a prominent role in the processing of rough diamonds, which involves sorting, planning, cutting, polishing, grading, etc.

Rating methodology

CARE Ratings Limited (CARE Ratings) has a detailed methodology for rating companies belonging to the manufacturing sector. CARE Ratings' rating process begins with the evaluation of the economy and industry in which the company operates, followed by the assessment of the business risk factors specific to the company. This is followed by an assessment of the financial and project-related risk factors as well as the quality of the management. This methodology is followed while analysing all the industries that come under the purview of the manufacturing sector.

However, considering the size and diversity of the manufacturing sector, CARE Ratings has developed methodologies specific to various industries within the sector. These methodologies attempt to bring out factors, over and above those mentioned in the broad methodology, which is considered while analysing companies belonging to an industry. CARE Ratings considers the following factors as critical determinants of credit risk associated with a particular industry.

Such additional factors considered by CARE Ratings, along with their analytical implications, while arriving at the rating of an entity that operates in the CPD segment have been discussed below.

A. Management evaluation

The CPD sector in India consists mainly of closely held family-owned entities that operate through a close-knit chain of entities encompassing the critical business aspects (purchase, processing, and sales), which are largely controlled by various family members or close relatives.

Key points assessed are:

i. The experience of the promoters or group in the CPD segment and their past track record of operations, especially during industry downturns and adverse macroeconomic environments.
ii. Financial flexibility of the group and past track record of fund infusion.

B. Business risk

i. Access to raw materials (rough diamonds)

Despite India being a leading manufacturer of CPD, it is dependent on its sole raw material, i.e., rough diamonds on miners and secondary markets located abroad. Rough diamonds are procured either directly from large mining companies (DTC, Alrosa, Rio Tinto, Dominion Diamond, etc) on a long-term contract basis (sight holder status, etc) or from secondary markets (mainly in Antwerp, Hong Kong, Dubai) through auction or spot basis. CARE Ratings considers the following factors while assessing the business risk associated with raw material procurement:

- Diversification of rough diamond procurement between primary and secondary sources.
- Tenure of sourcing arrangements with diamond mining companies.
- Supplier concentration levels.

CARE Ratings considers CPD entities having a diversified supplier base along with a long-standing association with the major diamond mining companies relatively better, as it entails an assured supply of rough diamonds, which helps in better production planning as per the requirements of its target customers. Long-term contracts with mining companies also signifies compliance with best and transparent business practices as well as the superior ability of an entity to market polished diamonds.

ii. Scale of operations and operating efficiency

CARE Ratings assesses the scale of operations and operational efficiency of a CPD entity in terms of its total operating income (TOI), the ability to process a wider variety of stones in terms of carats, and the level of yield obtained from processing a rough diamond. A higher scale of operations and better operating efficiency impart an advantage in terms of economies of scale and the superior ability to withstand cyclicality in demand and downturns in a business environment.

Revenue diversification: Geographical, customer, and product

Geographical diversification: Diamond jewellery demand is largely discretionary and has a strong correlation with the macroeconomic environment, which influences the consumer spending in the major diamond jewellery-consuming nations. Entities exhibiting diversified export sales are expected to be in a better position to mitigate the challenges arising from a decline in demand in a particular country, adverse changes in duty structure, imposition of trade restrictions or economic and political instability in a particular region.

CARE Ratings believes that entities having a well-diversified presence across geographies are likely to exhibit more stable operating performance by reducing the impact of adverse market scenarios witnessed in a particular region.

Customer mix: The CPD segment is primarily an export-oriented business, with the customer mix comprising traders (mainly in Antwerp, Hong Kong, and Dubai) and jewellery manufacturers and retailers (mainly in Hong Kong, the US, Europe, and Japan). Repeat orders from large and reputed jewellery manufacturers and retailers reflect consistency in the quality of an entity's polished diamonds (4Cs – cut, clarity, carat, and colour), timely delivery, and adherence to international best practices required in the rough diamond processing industry. Cumulatively, these factors impart a greater degree of sustainability to its business. Nevertheless, as the credentials of many export customers are not readily available in the public domain, sudden deterioration in the creditworthiness of overseas customers has adversely impacted the credit risk profile of CPD manufacturers.

A diversified clientele is looked upon more favourably by CARE Ratings, considering the industry practice of offering clean credit to customers, whereby, the risk of bad debt gets more exacerbated when sales and receivables are concentrated towards a few customers.

Product and sales channel diversification: CARE Ratings believes that a diversified product portfolio and a higher degree of integration across the value chain imparts greater flexibility in shifting the product offerings as per changing demand preferences in the key markets. CPD entities with a wider product portfolio (presence across various types of polished diamonds as well as engagement in the manufacturing of diamond-studded jewellery) are in a better position to cater to the demand of a diversified customer base, which in turn, helps in reducing the volatility of earnings. CARE Ratings also believes that the adoption of multiple sales channels (direct sales, online, associates, etc) reflects the CPD player’s wider market reach, acceptance, and business stability.

iii. Adoption of technology to maximise yield and grading of diamonds

Technological advancements (across the processing value chain) enable the manufacturer to reduce wastage, increase yield, and plan out the most profitable cutting and polishing option for a given rough diamond. The level of adoption of technology also enhances worker productivity, which is critical considering the industry is labour-intensive in nature. During the past few years, the certification of polished diamonds has gained importance to increase transparency, eliminate fakes and synthetics, and protect consumer interest in terms of quality assurance. CARE Ratings believes that a larger share of certified diamonds in the overall sales mix of a CPD manufacturer aids in a competitive market, where customers are becoming increasingly quality-conscious and are willing to pay a premium for third-party certification.

iv. Transactions with related parties

CARE Ratings endeavours to assess the nature and value of transactions of a CPD entity with related parties and associates along with the amounts due to or receivables from them and the overall financial position of such group companies. Lack of adequate information on key group and associate concerns is viewed negatively in the credit risk assessment of the CPD entity.

Furthermore, investments and loans and advances to associate concerns engaged in unrelated businesses are also appropriately factored in while assessing the credit risk of the CPD entity.

CARE Ratings considers the business risk profile of those CPD manufacturers to be favourable in case they have demonstrated a long track record of growth in their scale of operations across various industry cycles while generating free operating cash flows through efficient working capital management and earning superior profit before interest, lease rentals, depreciation and taxation (PBILDT) margin than the industry.

C. Financial risk

i. Large working capital requirements

Long operating cycles and high working capital intensity are often inherent characteristics of the entities in the CPD industry. CARE Ratings compares an entity's operating cycle in comparison to its peers and industry median to assess the level of its working capital intensity.

Upfront payment to miners for procuring rough diamonds, longer turnaround time in processing (including grading and certification of CPD), high inventory levels, and extension of long credit periods to its customers are inherent operating characteristics of entities in the CPD industry. All these factors cumulatively result in high working capital requirements.

CARE Ratings believes that entities that have faster inventory turnover, shorter receivable days, and enjoy credit from rough diamond traders are in a better position to generate healthy cash flow from operations.

For assessing the effectiveness of an entity's working capital management, CARE Ratings analyses the net working capital as a percentage of current assets, the manufacturer's major debtors including a party-wise breakup, its ageing, and movement over the years. Furthermore, entities demonstrating timeliness in realisation of their export bills and having a cushion in terms of unused working capital lines of credit, unencumbered liquid investments, etc, are viewed favourably.

ii. Foreign exchange fluctuation risk

Although the entities in the CPD industry enjoy a natural hedge, which mitigates the foreign exchange fluctuation risk to a certain extent, most of the entities lack an active hedging mechanism for their unhedged foreign currency exposure.

CARE Ratings believes that in the absence of an active hedging mechanism, steep fluctuation in exchange rates can adversely affect the earnings and cash flows of an entity. CARE Ratings evaluates the hedging mechanism adopted by the entities to access exchange rate risks.

D. Industry risk

Industry risk analysis by CARE Ratings focuses on the prospects of the industry and the competitive factors affecting the industry. The economic and industry environment is assessed to determine the degree of operating risk faced by an entity in the CPD segment. The evaluation of industry risk encompasses an assessment of key parameters like entry barriers in the industry, demand-supply dynamics, price trends, business cycles, etc.

A high degree of fragmentation, limited value addition, and intense competition result in thin profitability. Moreover, diamond jewellery demand is largely discretionary and has a strong correlation with growth in economic activity and real income levels. While prices of rough diamonds are determined by miners due to the oligopolistic nature of the segment, CPD prices are largely market-driven, based on demand-supply dynamics. As a result, CPD manufacturers have low bargaining power and are often the price takers at both ends of the spectrum and carries the risk of inventory holding and elongated receivables period in times of subdued demand scenario.

Apart from the above factors, instances of over-grading of diamonds, increasing penetration of synthetic diamonds (on account of the drastic reduction in its production cost due to technological innovations), and

competition from other fashion items and discretionary spending also exert -pressure on the demand and profitability of the CPD segment.
Inventory valuation is another area of concern in the industry due to the high diversity of diamonds, their technical nature and lack of homogeneity.

Environmental Social and Governance (ESG):
CARE Ratings in its overall credit rating framework directly or indirectly analyses the critical ESG risks and their impact on the credit profile of the entities in the CPD segment. CARE Ratings analyses the materiality of ESG risk factors and mitigating factors, if any, being implemented by the entity.
CPD entities faces social risks related to labour related risk. Further, compliance with the various labour laws and adequate safety for workers provide long-term sustainability.
CARE Ratings looks at the composition of the board of directors and track record of legal and statutory compliance by its management/ directors to understand the corporate governance structure. Further, the quality of disclosure related to financial statements, related party transactions and transparency in sharing information with various stakeholders are also helpful to gauge the corporate governance practices.

Conclusion

The rating process is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. CARE Ratings analyses each of the above factors and their interlinkages to arrive at the overall assessment of credit quality. The methodology encompasses a comprehensive analysis of business, financial, industry, and management parameters before arriving at the credit rating of an entity in the CPD segment. Rating determination is a matter of experienced and holistic judgment, based on the relevant quantitative and qualitative factors affecting the credit quality of the issuer.

(For the previous version, please refer to 'Rating Methodology: Cut and Polished Diamond (CPD) Industry' issued in October 2020).

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About:

CareEdge is a knowledge-based analytical group that aims to provide superior insights based on technology, data analytics and detailed research. CARE Ratings Ltd, the parent company in the group, is one of the leading credit rating agencies in India. Established in 1993, it has a credible track record of rating companies across multiple sectors and has played a pivotal role in developing the corporate debt market in India. The wholly-owned subsidiaries of CARE Ratings are (I) CARE Advisory, Research & Training Ltd, which offers customised advisory services, credible business research and analytical services (II) CARE Risk Solutions Private Ltd, which provides risk management solutions.