Rating Methodology – Cut & Polished Diamond (CPD) Industry

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Industry Overview

Since its emergence in 1970s, when Indian companies began cutting and processing very small diamonds (below 0.50 carats) for export, India has risen to be the world's largest diamond processing center. The Indian entities are often credited with creating a market for smaller polished diamonds.

Lower labour costs, operational efficiency and capability to adapt to new technologies are the factors that have made India a global leader in cutting and polishing of not only smaller diamonds but also larger carat stones. India's market share 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.

The CPD segment of the Indian G&J industry is primarily export driven and it contributes a significant portion to the Gross Domestic Product (GDP), net foreign exchange earnings (FEEs) and employment of the country. Majority of the diamonds polished in India are exported to key diamond jewellery manufacturing centers/ jewellery retailers based in Hong Kong/ China and USA. The other major diamond jewellery markets include Japan, Australia, Middle East, etc.

There are a series of processes that rough diamonds pass through before being sold in the retail market. The CPD industry plays a prominent role in it whereby some of the key processes involved are sorting, planning, cutting, polishing, grading, etc.

RATING METHODOLOGY

CARE Ratings (CARE) has a standard methodology for credit rating of the companies belonging to the manufacturing sector across industries. It encompasses an assessment of the various risk factors which could potentially affect the credit risk of an entity such as: economy and industry risk analysis, business risk, financial risk, management quality and project risk (if applicable).

However, considering the size and diversity of the manufacturing sector, CARE has devised methodologies specific to various industries within the sector. These methodologies attempt to point out factors, over and above those mentioned in the broader methodology devised for the manufacturing sector, which are considered while analyzing entities belonging to a particular industry.

Such additional factors considered by CARE, 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 and sales) which are largely controlled by various family members/close relatives.

Key points assessed are:

a. Experience of the promoters/group in the CPD segment and their past track record of operations especially during industry downturns and adverse macro-economic environment.

b. Financial flexibility of the group and past track record of fund infusion

B. BUSINESS RISK

a. Access to raw materials (rough diamonds)

Despite India being a leading manufacturer of CPD, it is totally dependent for 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/ Dubai) through auction or spot basis. CARE 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 considers CPD entities having diversified supplier base along with long-standing association with the major diamond mining companies relatively better as it entails assured supply of good-quality rough diamonds which helps in better production planning in accordance with requirements of its target customers and signifies compliance with best/transparent business practices as well as the superior ability of such an entity to market the polished diamonds.

b. Scale of operations & operating efficiency

CARE assesses the scale of operations and operational efficiency of a CPD entity in terms of its total operating income, revenue & customer diversification, ability to process wider variety of stones (size, shape, colour, etc.) and level of yield obtained from processing a rough diamond. Higher scale of operations and better operating efficiency imparts advantage in terms of economies of scale and superior ability to withstand cyclicality in demand/ downturns in 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 and factors which influence consumer spending in the major demand centers. Apart from catering to domestic demand, entities exhibiting diversified export sales are expected to be in a better position to meet the challenges arising from decline in demand in a particular country, adverse changes in duty structure, imposition of trade restrictions or political instability in a particular region. CARE 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 scenario witnessed in a particular region.

Customer Mix: The CPD segment is primarily an export-oriented business with the customer mix comprising of traders (mainly in Antwerp and Dubai) and jewellery manufacturers/retailers (mainly in Hong Kong, USA, Europe and Japan). Repeat orders from large and reputed jewellery manufacturers/ retailers are a reflection of consistency in quality parameters of an entity's polished diamonds (4C's – Cut, Clarity, Carat and Colour), timely delivery and adherence to international best practices required in the rough diamond processing industry, which cumulatively impart a greater degree of sustainability to its business.

Also, a diversified clientele is looked upon more favourably by CARE especially when as per industry practice sales in the CPD sector are in the nature of clean credit whereby the risk of bad debt gets more exacerbated when sales/receivables are concentrated towards few customers.

Product & Sales channel diversification: CARE believes that a diversified product portfolio and 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 engaged 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 volatility of earnings. CARE also believes that adoption of multiple sales channels (direct sales, online, associates, etc.) is a reflection of the CPD player's wider market reach, acceptance and business stability.

c. Adoption of technology to maximize yield and grading of diamonds

Technological advancements (especially in laser cutting machines) 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 last few years, certification of polished diamonds has gained importance in order to increase transparency, eliminate fakes/ synthetics and protect consumer interest in terms of quality assurance. CARE 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.

d. Transactions with related parties

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

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

CARE considers the business risk profile of those CPD manufacturers to be favourable who have demonstrated a long track record of growth in its scale of operations across various industry cycles while generating free operating cash flows through efficient working capital management and earning superior PBILDT margin than the industry.

C. FINANCIAL RISK

a. Large working capital requirements

Long operating cycle and high working capital intensity is often an inherent characteristic of the entities in the CPD industry. CARE 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, higher turnaround time in processing (including grading/certification of CPD) and extension of long credit period to its customers are inherent operating characteristics of the entities in the CPD industry. All these factors cumulatively result in high working capital requirement and necessitate adequate financing of working capital facilities from the bankers.

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

b. 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 active hedging mechanism for their unhedged foreign currency exposure which varies from one entity to another.

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

D. INDUSTRY RISK

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

High degree of fragmentation, limited value addition and intense competition results in thin profitability. Also, diamond jewellery demand is largely discretionary and has strong correlation with growth in the economic activity and real income levels. Furthermore, 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 a very low bargaining power and are often the price takers at both ends of the spectrum as well as are vested with higher inventory and receivables in times of subdued demand scenario. Also, 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 the CPD manufacturer. Apart from above factors, instances of over grading of diamonds, increasing penetration of synthetic diamonds (on account of drastic reduction in its production cost due to technological innovations) and competition from other competing fashion items/discretionary spends also exert pressure on demand and profitability of the CPD segment.

Inventory valuation is another area of concern in the industry. Due to high diversity of diamonds, its technical nature and lack of homogeneity, inventory valuation method adopted by entities are generally not as per the Indian Accounting Standard -2 (IND AS-2).

CONCLUSION

The rating process is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. CARE analyses each of the above factors and their inter-linkages to arrive at the overall assessment of credit quality. The methodology encompasses 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 previous version please refer 'Rating Methodology – CPD Industry' issued in September 2019]

CARE Ratings Limited

4th Floor, Godrej Coliseum, Somaiya Hospital Road,
Off Eastern Express Highway, Sion (East), Mumbai - 400 022.
Tel: +91-22-6754 3456, Fax: +91-22- 6754 3457, E-mail: care@careratings.com