CPD Exports Cautious After Strong FY22 Show, Margin Dip Imminent

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Synopsis

- Indian cut and polished diamond (CPD) players recovered significantly in FY22, crossing the pre-pandemic levels by a fair margin, as the demand for diamond jewellery reached an all-time high of USD 87 billion, primarily due to robust demand from the US.
- The exports of CPD remained stable at USD 12.2 billion during H1FY23 (H1FY22: USD 12.3 billion), despite the absence of Russian rough. However, amid the inflationary pressures, a slowdown in China and geopolitical uncertainties, CareEdge Ratings believes the demand for retail diamond jewellery during the approaching holiday and wedding season in the key diamond jewellery-consuming nations will be crucial.
- CareEdge Ratings expects the aforementioned factors will outweigh the exports of CPD once the operations at Surat resume post-Diwali break. The export volumes are likely to be impacted even higher, which is already lower by around 22.5% in 7MFY23, partially due to the absence of Alrosa's smaller goods.

Evolution of Digital Channels

The diamond industry has largely been a physical industry starting with manual inspection of rough diamonds by sight holders and alliance members, attending diamond trade shows and finally, retail jewellery sales, wherein less than 10% of diamond jewellery sales were sold online.

Travel restrictions due to the coronavirus pandemic, and varying degrees and extent of lockdowns mandated alignment of trade practices to the new reality through the development of digital channels across the natural diamond value chain, ie, mining – processing – manufacturing and retail.

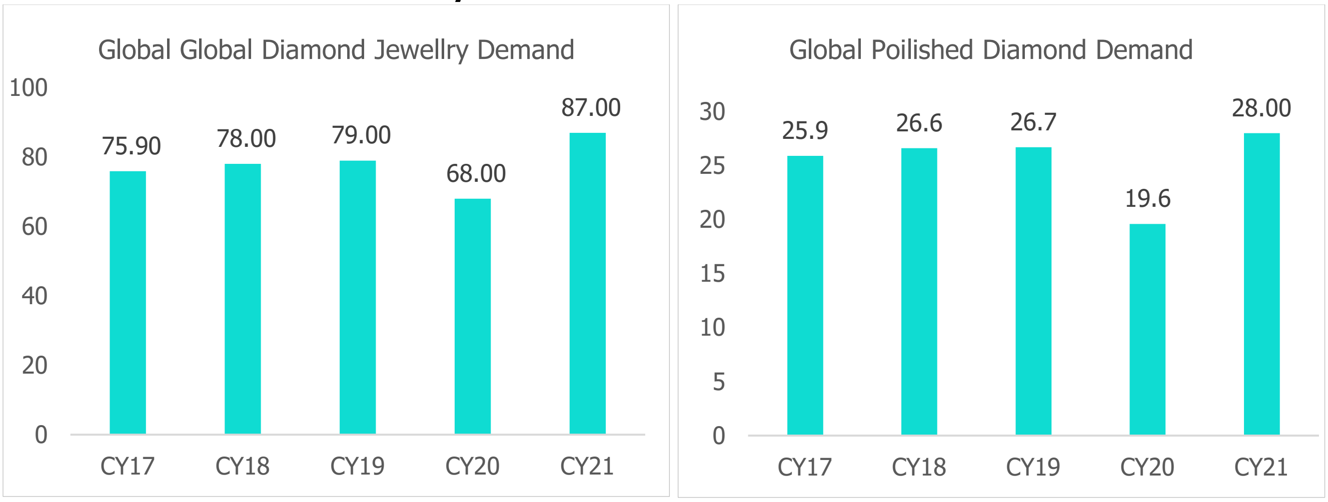
Major mining companies focused on online sales through auctions and 3D scans and revisited allocations to minimise speculative sentiment. Local beneficiation plans gained importance as well. In the midstream segment, the entities focused on improving efficiency through automation and developed direct-to-customer sales channels including online sales of certified diamonds through proprietary online platforms. More conservative financing policies were also adopted by the segment. The lack of lifestyle-based spending and government stimulus drove consumer demand.

Demand for Natural Diamonds Crossed Pre-Covid Levels in CY21

The global natural diamond jewellery demand and global polished diamond demand witnessed a robust recovery at US $87 billion and US $28 billion, respectively, in CY21, crossing pre-pandemic levels of CY19 by around 10%. The year-on-year (YoY) growth of natural diamond jewellery demand was significant at 29% and consequently polished diamonds demand grew by 51% on a YoY basis in CY21. Over and above the fiscal stimulus, the lack of alternatives in terms of other luxury spending, experience-based activities, travelling, etc., made diamonds a preferred choice for customers, which had excess liquidity due to a reduction in the overall expenditure. Moreso, the reduction in unemployment rates and vaccination drives in the second half of the financial year resulted in faster inventory turnover and earlier-than-usual orders for depleted inventories.

Presently, more than half of the global natural diamond jewellery demand is contributed by the US, followed by China and Japan, which accounted for about 11% and 5%, respectively, in CY21.

Chart 1: Global Diamond Jewellery and Polished Diamond Demand



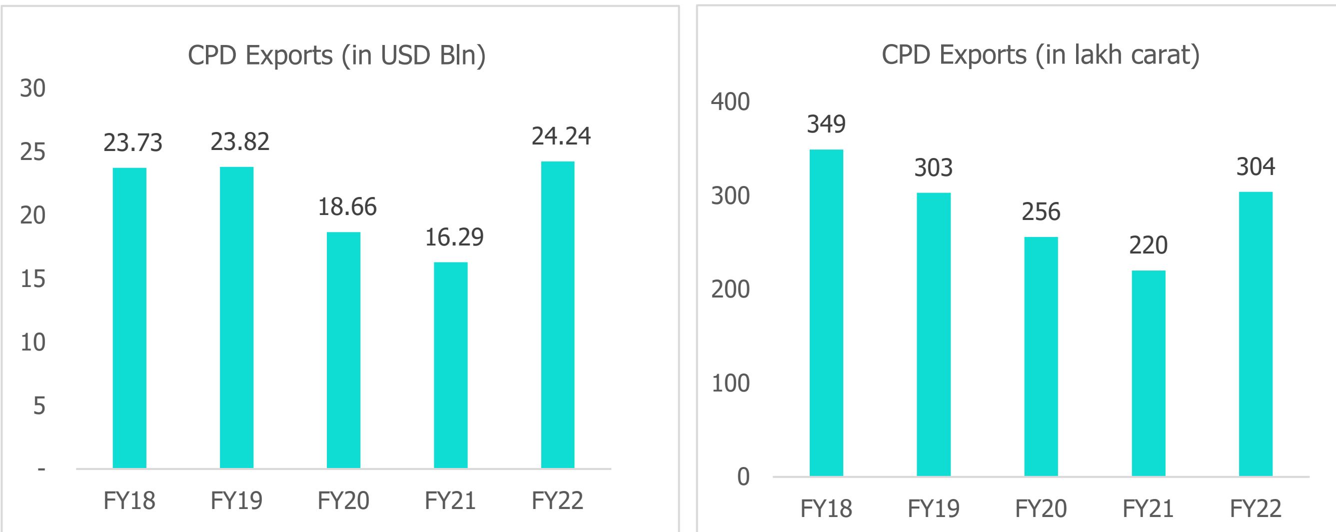
Source: De beers Insight report

Midstream Segment Mirrors Industry Performance

The midstream segment, dominated by Indian entities, reflected a mirror image of the industry performance post-Covid-19 marked by a steady increase in the overall exports since Q2FY21. Moreso, it also ended a prolonged state of decline in the CPD prices.

India is the world's largest centre for cutting and polishing diamonds with most players concentrated in the two cities of Gujarat- Surat and Navsari. With a global share of more than 90% in the processing of rough diamonds, CPD accounted for 53% of the overall gems and jewellery exports from India. After robust growth in demand in FY19, FY20 was muted due to the adverse macro-economic environment amid the US-China trade war, political unrest in Hong Kong and the early impact of Covid-19. The recovery in demand after the lifting of lockdown restrictions in the US and China resulted in a faster-than-envisaged recovery in demand from Q2FY21 onwards, which continued till Q4FY22.

Chart 2: CPD Exports from India



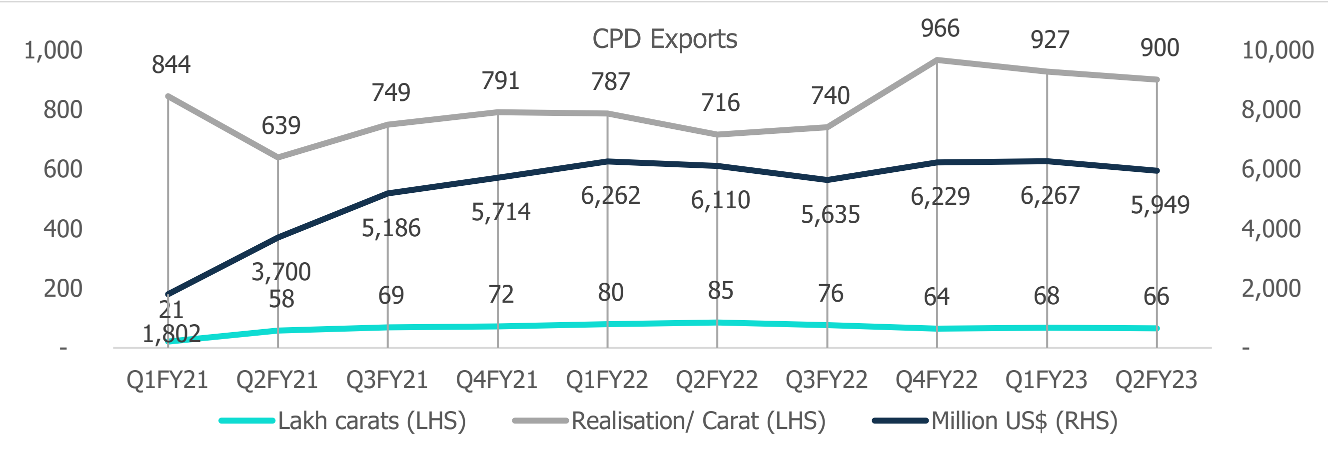
Source: GJEPC

Impact of War and Macro-economic Environment on CPD Exports

Since Q2FY21, exports of CPD have increased for five straight quarters till Q2FY22. It fell in Q3FY22 due to the Diwali break in November 2021. Contrary to the expectation of softening in the rough diamond prices after the Diwali break, it continued to increase creating an imbalance in the pricing parity of rough diamond vs polished diamond prices, marked by an increase in CPD exports by 11% to USD 6.2 billion with a decline in volume by 15% to 64 lakh carats in Q4FY22 over Q3FY22. On an annual basis, exports of CPD rebounded significantly by 49% y-o-y to USD 24 billion.

The Russian invasion of Ukraine in February 2022 spiked the prices of both rough as well as CPD to nearly a decade high. In CY21, Alrosa produced 32.4 million carats of rough diamonds valued at USD 2.9 billion, accounting for about 25% of global production and 24% of the value of the total global rough production. Moreover, it commands about 40%-50% market share in smaller-sized diamonds. As a result, while CPD exports (in volume terms) declined by 19% during H1FY23, as compared with H1FY22, exports (in value terms) remained largely stable at USD 12.2 billion in H1FY23. The increase in sales realisation also reflects a dip in the consumer demand from China, which consumes smaller-sized goods below 0.30-carat diamonds as compared to the US, which consumes larger sizes/ higher-value stones.

Chart 3: CPD Exports from India

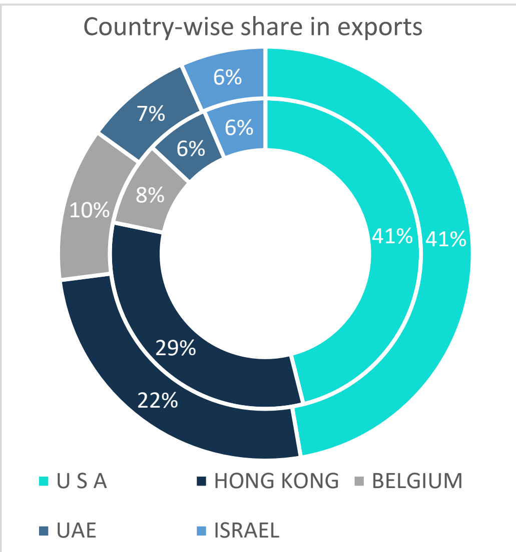


Source: GJEPC

Overall exports of CPD to the US remained stable at USD 4.1 billion during 5MFY23 and accounted for 41% of total exports. Exports to China (the second-largest export market) reduced due to a resurgence of Covid-19 and its zero-tolerance policy leading to intermittent lockdowns. Furthermore, real estate and banking crisis impacted consumer demand for discretionary products, including CPD, leading to a reduction in exports by 26% to USD 2.2 billion. Other major CPD export destinations reported either stable or marginal improvement in exports.

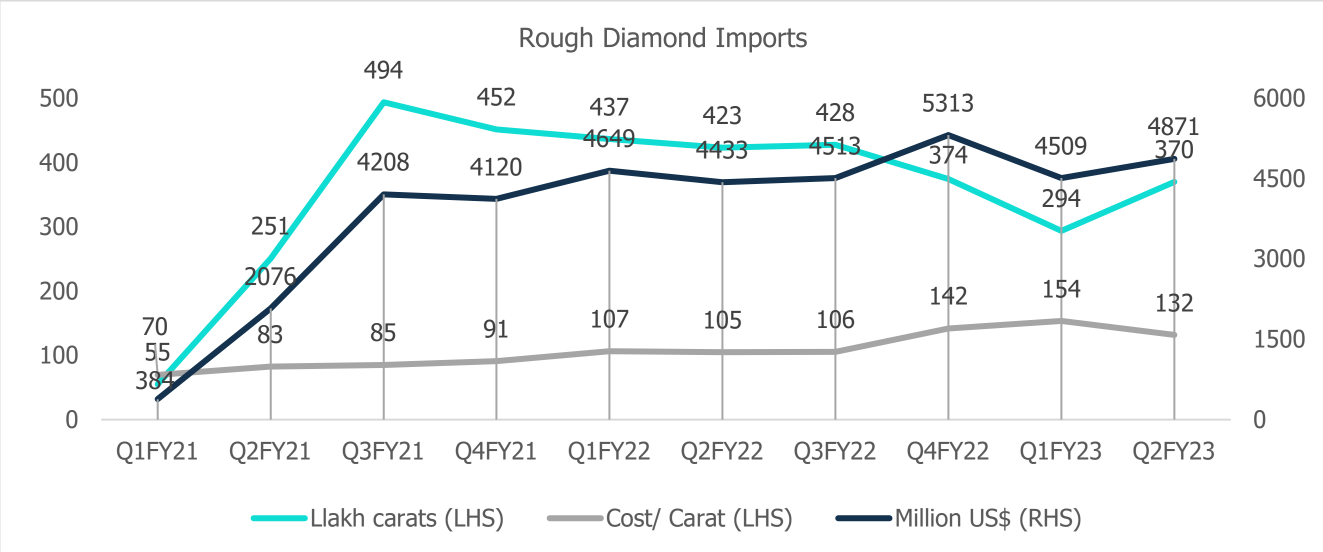
Rough diamond imports increased with the resumption of operations and reflected an increasing trend in value terms till Q4FY22. However, it was primarily due to increase in the rough diamond prices as there was m-o-m drop in volume from Q2FY21 till Q1FY23.

Chart 4: Country-wise CPD exports



Disruption in supply from the largest rough diamond miner along with the lack of demand for CPD from China has forced small and mid-sized entities in the midstream segment to contain their operational activities, as compared to a similar period in the previous year. The same can be corroborated by the sharp decline in the volume of rough diamonds imports witnessed in Q1FY23. The average cost of rough diamond imports increased by 30% m-o-m in March 2022 and April 2022 to USD 217 in April 2022 from USD 126 in February 2022 on account of uncertainty w.r.t rough diamond availability following the sanctions imposed by the US. Although the prices have reduced marginally in Q2FY23, it was higher by 25% when compared with Q2FY22. In addition, the increase in the procurement price per carat during H1FY23 to a certain extent reflects the absence of Alrosa, which is estimated to have the largest share in smaller-size diamonds.

Chart 5: Rough Diamond Imports



Source: GJEPC

De beers became a primary supplier of rough diamonds and reported healthy growth in sales, primarily backed by the increase in the prices. During its first eight sights for CY22, De beers reported rough diamond sales of USD 4.1 billion as against USD 4.2 billion in CY21. During H1CY22, while De beers' rough diamond sales in volume reduced by 20%, its price index increased by 28% to USD 213/ per carat.

Way Ahead

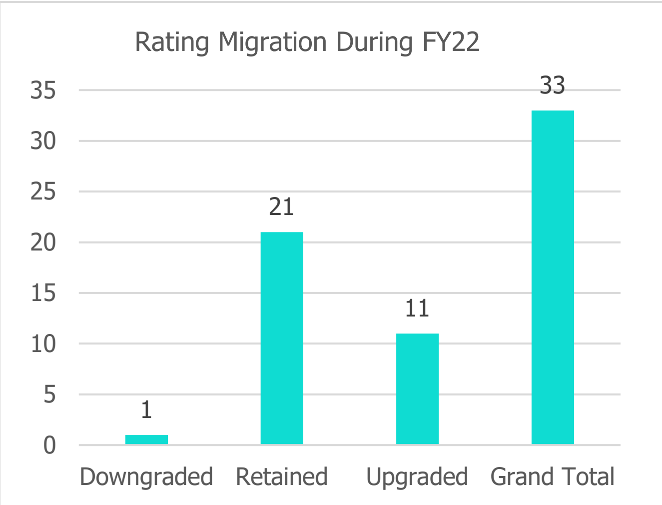
Overstimulation of the US economy with more than USD 5 trillion in stimulus payments followed by Russia's invasion of Ukraine has build-up inflationary pressure on essentials like clothing, food and energy. Strong recovery of the entire diamond value chain post lifting of lockdown restrictions due to the lack of alternate avenues for spending on the backdrop of overstimulated economies buoyed the demand of diamond jewellery. The outlook is now overturning with a decrease in disposable income on the backdrop of withdrawal of excess liquidity, the surge in inflation across all key economies and decadal high interest rates. Moreover, the situation is further exacerbated by the zero-tolerance stance of the Chinese government leading to intermittent lockdowns in various key cities, domestic property, and a banking crisis in China, the second-largest diamond jewellery market in the world.

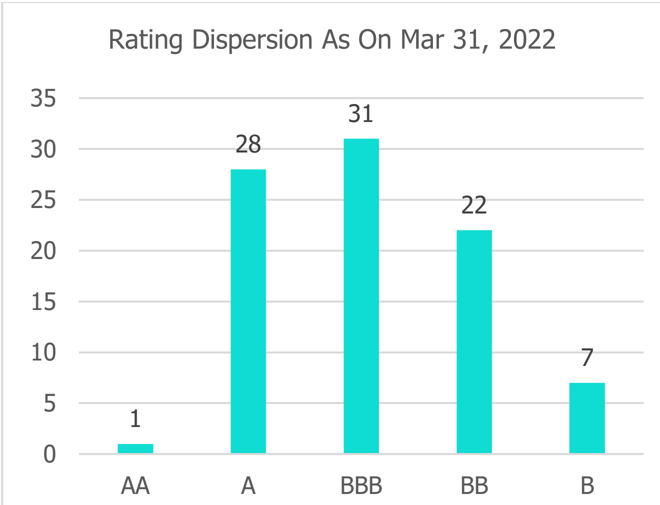
Against this backdrop, recovery in demand from these two key consuming nations remains crucial for the overall performance of the Indian midstream segment in FY23. Most of the dealers in the US have stocked jewellery for the forthcoming season, and hence sales during the forthcoming holiday season remain a key monitorable for a revival of rough diamond processing operations for the Indian midstream segment.

CareEdge Ratings expects the entities operating on a moderate scale with dependence on the secondary market to be impacted more when compared with entities having long-term supply contracts at both ends of the value chain. With the focus of the entire value chain to improve efficiency, reduce speculative movements in the prices, and promote sustainable and ethical luxury, we expect organised players with mine-to-market partnerships will continue to gain a larger market share in the near to medium term.

Impact on Credit Profiles

Of the G&J companies rated by us, 67% are in the investment grade category. Furthermore, on the back of improved demand from the end-user segment as well as the conservative approach adopted by the players, the Modified Credit Ratio (MCR) ratio has seen an improvement to 1.22x in FY22. Considering that the debt profile of the entities in the CPD sector consists primarily of working capital borrowings, overall leverage and coverage metrics are expected to remain stable, albeit the total operating income and margins to witness a decline in FY23.





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