RAPAPORT
RESEARCH REPORT

CREDIT TO THE DIAMOND INDUSTRY
Overstocked and underpaid?

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MARKET PULSE

Diamond dealers started 2018 with optimism for the year ahead. Polished prices remained firm in December and January, supported by expectations of higher rough prices at the first De Beers sight (January 22 to 25, beginning after press time), as well as of steady orders from retailers replenishing stock after the holiday season.

Meanwhile, manufacturers are preparing to ramp up polished production. Indian factories have operated at around 70% capacity since the November Diwali break, and polished inventory has been depleted. Rough trading therefore improved ahead of the sight, and a large volume of rough was projected to enter the market in anticipation of a spike in polished demand during the first quarter.

Jewelers in the US had a better holiday season than expected, with good high-end, solitaire and fashion jewelry sales, though engagement rings and wedding bands did not perform as strongly. There was steady spending by locals as consumer confidence received a boost from economic growth, soaring equity markets and tax cuts. The weak dollar is expected to boost tourist spending there as well. In China and Hong Kong, the retail market is waking up for the Chinese New Year, which falls out on February 16.

Rapaport expects a positive first quarter, with some polished price appreciation. Rough prices need to remain stable in order for manufacturers' profit margins to improve.

TREND WATCH

Automated grading: Sarine is planning to open its first grading lab in February in Israel, putting it in direct competition with the likes of the Gemological Institute of America (GIA), HRD Antwerp, the International Gemological Institute (IGI) and De Beers' International Institute of Diamond Grading & Research (IIDGR). Sarine, a technology company, claims to have fully automated the grading process, including for color and clarity, thereby eliminating the subjective nature of diamond grading.

Blockchain: De Beers is piloting a blockchain system for diamonds, with the intention of making it an open platform when it launches later this year. Creating a decentralized database that traces transactions throughout the diamond's journey will increase transparency in the trade. ■

THE MONTH IN NUMBERS

910 ct.
Rough diamond found at Letšeng mine believed to be fifth-largest in history.

$5.3 billion
Estimated De Beers sales for 2017, which declined 5% according to Rapaport calculations.

26,031
US jewelry businesses operating at the end of 2017, 3.8% fewer than a year earlier.

$23.1 billion
India's full-year polished exports, up by an estimated 2%.

+5.9%
Jewelry sales growth during the holiday season, according to MasterCard SpendingPulse.

+12%
Chow Tai Fook's Oct.-Dec. sales gains in mainland China.

INTRODUCTION

Avi Krawitz
Senior Analyst, Rapaport

There's an underlying mistrust between the diamond trade and its financiers. Diamantaires argue that the banks have an unjustified high-risk perception about the industry, while the banks are pressing the trade to operate more efficiently and raise its compliance standards.

To an extent, both are right. The diamond trade has come a long way, gradually abandoning its informal structures and handshake method of doing business. However, it also has a long way to go to meet the required reporting and compliance criteria.

The industry needs to be less combative toward the banks and should focus on improving its so-called "bankability" — defined by one executive as the sum of profitability, transparency and reputation.

After all, diamantaires need the banks more than the banks need them.

The banks are facing higher compliance requirements of their own. The Basel Accords, which imposed new banking regulations three decades ago, tightened further after the 2008 financial crisis, and the banks are passing that on to their clients in all industries.

The slow rate at which the diamond trade has met those new standards — combined with the industry's low profit margins — has resulted in the banks adopting a cautious attitude toward the sector. A number of stalwart financial institutions have recently closed their diamond branches or reduced their exposure to the industry.

Some of that lost credit is being replaced by new banks entering the market, or the introduction of other financial instruments. As such, we believe the industry currently has sufficient funding — at an estimated $13 billion to $14 billion — to sustain future growth.

Ultimately, the requirements the banks have outlined are necessary for diamonds to become a more efficient, profitable and appealing market.

This January edition of the new Rapaport Research Report presents a snapshot of the diamond market over the last month, with an in-depth focus on credit to the industry. It details the issues affecting the relationship between the trade and the banks, and highlights the steps that midstream manufacturers and dealers need to take to prove their bankability to financiers.

If credit is the oxygen sustaining the diamond midstream, more is not necessarily going to ensure its growth. Rather, the industry needs to realize it can survive (and, in fact, thrive) by relying less on the banks. ■

EXECUTIVE SUMMARY

The midstream diamond sector has been forced to change the way it operates as the banking environment has evolved. But there is ongoing tension between the banks and the trade regarding whether the industry has enough credit to facilitate growth. This report outlines that dynamic with the following key findings:

- The banks emerged from the 2008 financial crisis more risk-averse, requiring clients to meet stringent compliance standards.

- The diamond industry has been a slow adapter to the new regulatory environment and is considered a high-risk sector by the banks.

- The amount of credit extended to the diamond midstream is currently estimated at between $13 billion and $14 billion.

- The industry is not facing a liquidity crisis at this time, as that amount of credit is sufficient for rough purchases valued at around $12.5 billion a year.

- However, the midstream has emerged as the inventory depository for the industry, as the major miners have stopped stockpiling rough, and jewelry retailers have reduced their inventory and are taking more goods on memo.

- The midstream buys rough for cash and largely sells its polished on credit. It therefore needs to maintain large inventories to support retailers, and requires bank financing to do so.

- The banks are lending more conservatively and require diamantaires to self-finance up to 30% of their rough purchases.

- Three major banks have closed their diamond branches in the past three years, resulting in more than $2 billion worth of credit shifting to other banks, or leaving the trade.

- Alternative financing is gaining traction, but it's not for everyone and will constitute a small proportion of industry funding.

- The diamond trade needs to improve its relations with the banks by proving its "bankability." It can do so by improving its profit, transparency and reputation.

- Profit: Polished prices must rise and rough prices need to decline to enable better profit margins.

- Transparency: The industry is steadily adopting more corporate structures, but needs to do more to meet global standards. There is better invoicing, and the major manufacturers are providing audited financial statements in accordance with International Financial Reporting Standards (IFRS).

- Various traceability and know-your-customer programs, as well as initiatives to create a diamond blockchain, will raise transparency in the trade.

- Reputation: The diamond sector needs to be extra vigilant to enhance its reputation, given the unfortunate history of diamonds being used to fuel conflict, finance terror and launder money.

- The midstream has come a long way toward safeguarding against these issues. But in order to boost its creditworthiness, the industry needs to demonstrate consistently to the banks that it's making a positive contribution, has nothing to hide, and has a consistent flow of orders.

IMAGE: De Beers

THE STATE OF DIAMOND FINANCING

The diamond trade is adjusting to a new financial reality — one in which the midstream plays a much more prominent role than in the past. That sector, consisting of dealers and manufacturers, is effectively serving as both the industry's credit facility and its inventory depository, marking a drastic change from just over 10 years ago.

Unfortunately, this change has come at a time when banks are increasingly reluctant to extend credit to the diamond trade, putting pressure on manufacturers that now need it more than ever.

HOW DID WE GET HERE?

Historically, De Beers bore the industry's inventory burden by stockpiling rough, while jewelry retailers were willing to purchase inventory and hold it until it eventually got sold, former De Beers executive Varda Shine explained recently in Dubai.

However, two things happened that impacted the financing landscape, according to Shine. In the late 1990s, many retailers moved to memo (consignment) arrangements with diamond suppliers, requiring dealers to hold more of the trade's inventory. Then, in the early 2000s, De Beers sold its stockpile of rough as part of efforts to break its monopoly, shifting more of that rough toward manufacturers.

Following the 2008 financial crisis, global rough production declined (see graph) to align with retailers' lower stock requirements and De Beers' change in focus to operate profitable mines rather than accumulate supply. Today, producers aim to sell all their rough production to the midstream.

Meanwhile, the recession happened just as millennials were emerging as the core engagement-ring customers. Consumer habits and tastes began to change, and retailers became more selective in the goods they were stocking. Demand for diamond jewelry also stagnated in the absence of any industry-wide category marketing and as new luxury products in the tech space competed for the consumer's wallet. Retailers avoided holding excess inventory, having found themselves stuck with a surplus after the 2008 downturn.

At the same time, the financial crisis drove the banks to raise their compliance requirements via the Basel accords — regulations that aimed to reduce the risks of lending. Companies with tight margins and non-transparent ways of operating — of which there were many in the diamond industry — became less desirable clients.

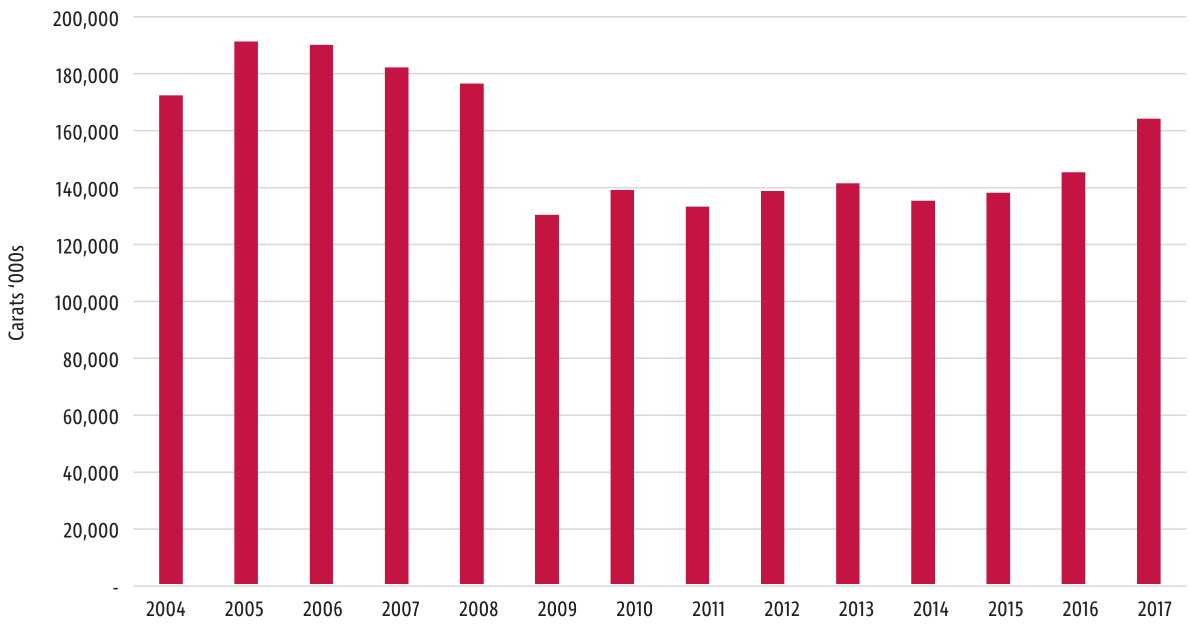
All those developments have created the perfect storm for the diamond midstream.

TOO MUCH CREDIT...

Depending on whom you ask, the amount of credit extended to the diamond midstream is currently between $13 billion and $14 billion — likely on the higher end of that range, according to Rapaport estimates, with about half of it in India. But is that enough to sustain the trade?

When it comes to buying rough, manufacturers pay up front, and they turn to banks to finance those purchases. Considering miners sold an estimated $12.5 billion of rough in 2017, it seems as if the industry is getting sufficient support from the banking sector.

GLOBAL ROUGH-DIAMOND PRODUCTION



Based on Kimberley Process data and Rapaport estimates for 2017.

THE STATE OF DIAMOND FINANCING

In fact, at a recent conference in Dubai, banking executives (pictured, Page 7) claimed the industry could function with as little as $8 billion. Of the current amount, they estimated, around $2 billion to $3 billion is in non-performing assets — loans that are in default or arrears, and are therefore dispensable.

As such, most banking officials who spoke with Rapaport agreed the diamond trade was not facing a liquidity crisis at this time.

...AND TOO MUCH STOCK

Meanwhile, the banks are expecting more diamond companies to close, claiming the midstream is congested with too many players and too many stones. As the trade consolidates, they believe, less funding will be necessary.

Indeed, the diamond sector is still operating in an oversupply environment, with inventory largely stuck in the midstream. That is part of a long-term correction the polished-diamond market is undergoing, resulting in a prolonged decline in polished prices. The RapNet Diamond Index (RAPI™) fell for the sixth straight year in 2017 (see graph).

But that stock allocation is precisely why the trade argues it *does* need more financing. Not only does the midstream need to maintain large inventories to support retailers, it is also under pressure from changing consumer habits, and from tighter profits due to relatively high rough prices vis-à-vis polished ones.

After buying rough for cash from miners, manufacturers typically sell the resulting polished to jewelers on credit terms — that is, if they sell it at all, since a lot of goods go out on memo or simply sit in inventory waiting for demand to turn. By conservative estimates, it can take an average of six to nine months for manufacturers to get money back from their initial outlay on rough.

SET IN ITS WAYS

This arrangement is not expected to change. The mining companies are unlikely to extend credit, since they say they need the immediate cash flow to fund investment in their mines. Meanwhile, jewelers are becoming increasingly frugal as they adapt to consumer spending shifts.

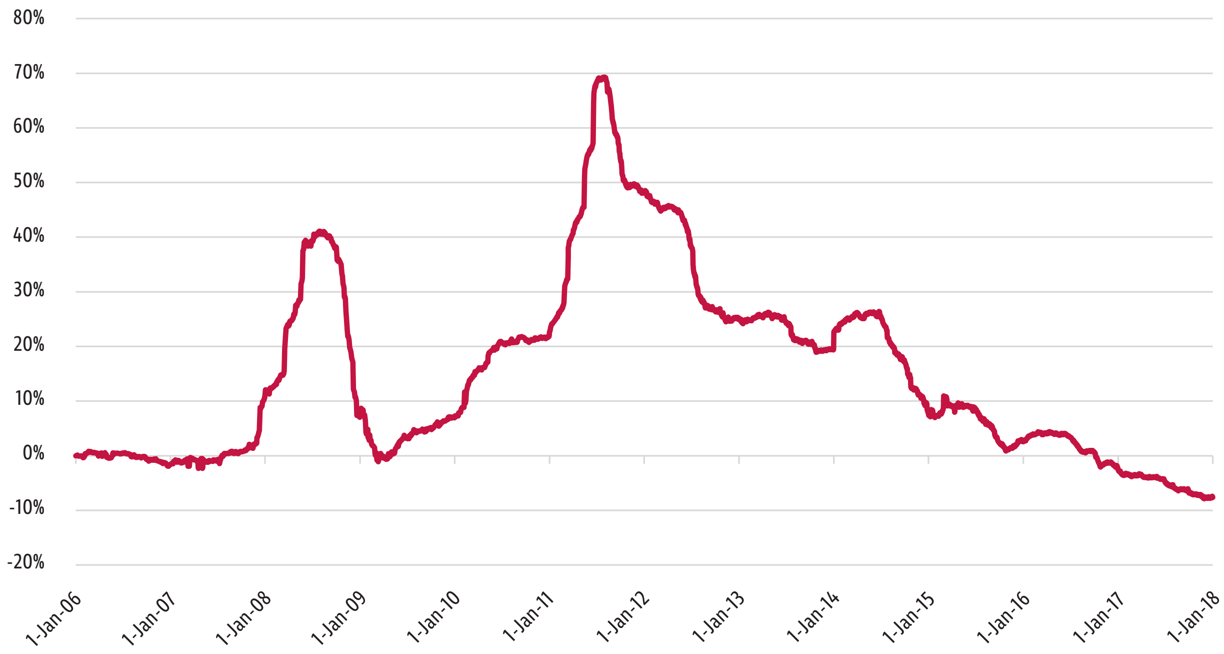
This means the midstream remains the industry's de facto banking facility and inventory-holder for the foreseeable future. And that, in turn, means it will continue to need financing.

BANKS PULLING OUT

Bankers, however, want diamantaires to put more of their own skin in the game. In 2014, ABN Amro reduced its credit facility for rough purchases from 100% to 70%, and other banks followed suit. Diamantaires are consequently self-financing around 30% of their rough purchases.

The banks considered the move a return to normal standards after a history of being too lenient with their lending terms for diamond clients. They also noted that the reduction in credit facilities was not affecting rough buying, implying that the 70:30 ratio was manageable for the trade.

RAPNET DIAMOND INDEX (RAPI™) FOR 1 CT.



The RapNet Diamond Index (RAPI™) is the average asking price in hundred $/ct. of the 10% best-priced diamonds, for each of the top 25 quality round diamonds (D-H, IF-VS2, GIA-graded, RapSpec-A3 or better) offered for sale on RapNet – Rapaport Diamond Trading Network.

Of greater concern is that other banks have simply closed their doors. In the past three years, Antwerp Diamond Bank (ADB), Standard Chartered Bank, and Israel's Bank Leumi all discontinued their diamond funding, resulting in more than $2 billion worth of credit leaving the trade.

The market isn't yet feeling that missing credit, as it will take some time for those accounts to close completely. But that will change eventually.

NEW SOURCES OF FUNDING

Other banks are taking on some of ADB's, Standard Chartered's and Bank Leumi's clients. But they're cherry-picking the best of them. Banks in Belgium, in particular, are being highly selective about their diamond customers.

Amid the bankers' caution, diamantaires are exploring alternative financing options, including peer-to-peer financing, inventory or receivables securitization, and equity-issuing.

Securitization by investors (see Appendix, Page 14) is not a new mechanism, but it is gaining momentum of late. Still, it's not a quick fix, and it's not for everyone. Few diamantaires have the operational efficiency, transparency and scale to work in the capital market. Those that can are seeing it as an appealing option to secure long-term funding.

Even so, these alternatives account for a small portion of industry financing, currently totaling an estimated $400 million to $500 million. It is up to the banks to provide the bulk of the industry's funding. And it's up to the trade to prove that it is worthy of that credit by demonstrating its bankability. ■

IMAGE: Dubai Multi-Commodities Centre (DMCC)

Bankers participating in the recent Dubai Diamond Conference claimed the industry was over-financed.

PROVING BANKABILITY

How does a diamantaire obtain bank credit? The banker's rule is simple: There is financing available for "good" companies. As long as a business has a steady flow of invoices, the banks will not cut off its supply of credit.

But concerns remain among bankers regarding the diamond trade, largely due to its low profits; manufacturers are operating with tight margins, estimated at around 2% to 4%. The industry's slow progress toward becoming a more transparent market, along with negative perceptions of the way it operates, has also led banks to view diamonds as a high-risk business.

To state the obvious, the industry needs to show it's *not* a high-risk business. It can prove its creditworthiness — or bankability — by boosting its profit, being more transparent and actively working to improve its reputation.

It's not just individual businesses that need to tackle these issues, but the trade as a whole. The banks argue that this will likely require continued consolidation and downsizing of the midstream, but active steps can stimulate growth.

Here, we outline the issues fueling caution among the banks, while acknowledging some of the progress the trade has made toward being more bankable.

STIMULATING GROWTH

Among the biggest challenges the industry is facing are profitability and growth. While other industries have boomed over the past decade, the diamond trade has stagnated. Diamond-jewelry sales increased by less than 2% in the four years leading up to 2016, when the sum stood at $80.1 billion, according to the latest De Beers Insight Report (see graph).

The absence of category marketing for diamonds has contributed to the slow growth. It was only in the past year that the Diamond Producers Association (DPA) launched its "Real Is Rare" campaign with the goal of raising demand, expanding the range of diamonds that consumers buy, and pushing up polished prices.

With those prices declining in the past six years and moving out of sync with rough prices (see graph, Page 9), the trade needs to improve its margins. While polished prices have to increase, rough prices must decline for manufacturing profits to improve.

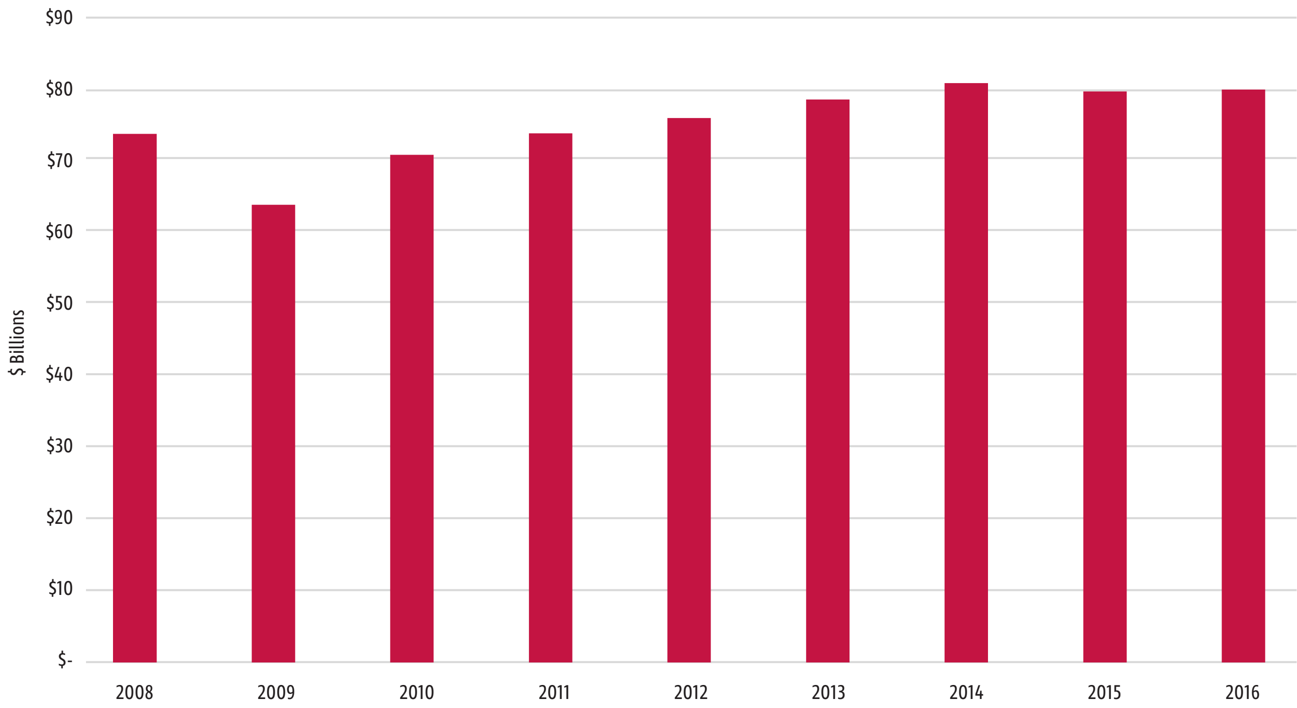
Rough prices are not likely to drop in a significant way this year, as the mining companies saw lower sales in 2017 and will want to resume growth, while production is expected to remain about in line with last year's levels.

To widen its profit margins, the midstream must operate more efficiently. Greater use of technological innovation will help modernize the trade and lower costs, as it has been a slow adopter of tech. More diamantaires — who can't compete with mass producers, predominantly in India — are shifting to niche products, which will improve their chances of profiting in a crowded market.

THE ROAD TO TRANSPARENCY

Historically, the diamond industry operated on a basis of trust, with deals sealed on a handshake and a declaration of "*mazal u'vracha,*"

GLOBAL CONSUMER DEMAND FOR DIAMOND JEWELRY



Based on data from De Beers Insight reports.

a traditional Hebrew blessing for good fortune. That had to change after the 2008 financial crisis, when compliance issues became more pressing for banks and regulators, and issues of ethical sourcing and traceability became more important to consumers.

The diamond industry is consequently undergoing a process of corporatization. Starting in 2018, to qualify as a De Beers sightholder, manufacturers must present audited financial statements in compliance with International Financial Reporting Standards (IFRS). Other mining companies, such as Alrosa, are also requiring IFRS reporting from their clients, while third-party audits are certainly a prerequisite to obtaining bank financing.

That means keeping proper invoices and transparent records of transactions. Most of the larger manufacturers have met that standard, or at least they will during the current fiscal year. Smaller operations still have some way to go in that regard.

PROVIDING COLLATERAL

Bankers, meanwhile, are encouraged by the new tax regimes in Belgium and Israel, saying the legislation will strengthen companies' balance sheets.

When deciding whether to lend to a diamantaire, banks want to see businesses that are well capitalized — i.e. that have sufficient debt or cash flow. As a result, they've shifted to financing based on trade receivables, or orders, rather than on inventory, which used to be the more prevalent method.

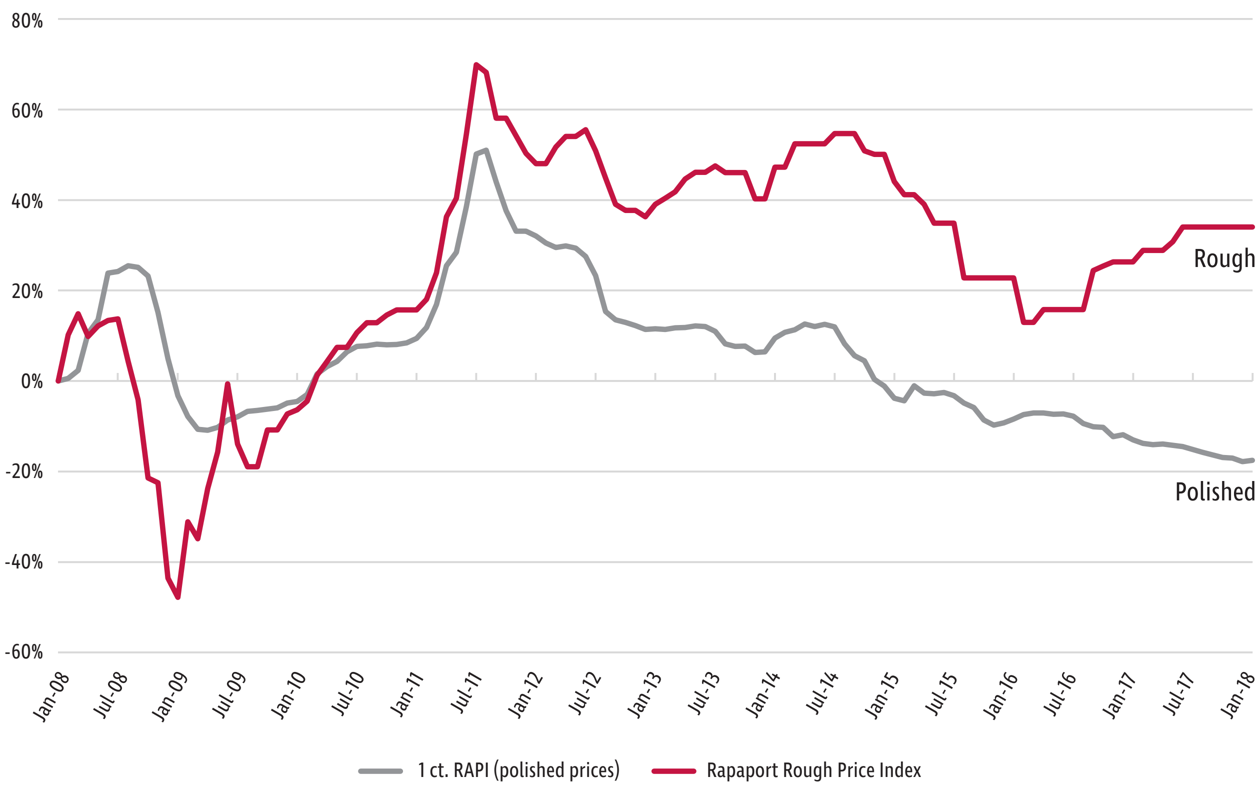
For a manufacturer to secure financing for a rough purchase, it must therefore provide outstanding invoices as collateral, or show it has an order for the resulting polished.

Most bankers don't lend based on inventory, because diamond stock, given its mobile nature, is difficult to collateralize. At a given time, a diamond may be in any of several places in the world, for cutting and polishing, trading or grading, or out on memo.

The banks have a particular distaste for memo, explains Robert Hoberman, a managing partner at accounting firm Hoberman & Lesser. It's a bank's worst-case scenario, because the goods are not in its clients' control, and it's not an order or sale. So what is a bank going to do, he asks, if one defaults on the loan? How will it get those goods back?

To alleviate that risk, the diamond business is relying on strong relationships more than ever. Diamond suppliers working

POLISHED VS. ROUGH PRICE TRENDS



The RapNet Diamond Index (RAPI™) is the average asking price in hundred $/ct. of the 10% best-priced diamonds, for each of the top 25 quality round diamonds (D-H, IF-VS2, GIA-graded, RapSpec-A3 or better) offered for sale on RapNet – Rapaport Diamond Trading Network.

with memo arrangements need to know their customers, and demonstrate their history in working with a client to whom they're supplying goods on memo.

KNOW YOUR TRANSACTION

Dealers are working more directly with retail clients, and there has been a notable decline in inter-dealer trading in recent years. A lot of goods are going out on memo to raise the chances of selling inventory that is otherwise difficult to move.

Suppliers also need to know their suppliers. From the retailers' perspective, jewelers increasingly require suppliers to verify where their goods came from. For example, to work with Signet Jewelers, the largest jeweler in the US, a supplier must be a member of the Responsible Jewellery Council (RJC), a body that sets responsible sourcing practices for diamonds, gold and platinum-group metals. Signet, through its responsible sourcing protocols, also encourages its clients to purchase their goods only from other RJC members.

Participation in know-your-customer (KYC) programs is helping to raise transparency in the trade. MyKYCBank — developed by India's Gem & Jewellery Export Promotion Council (GJEPC) — creates a centralized database with the details of participating companies, which they can pass on to others in the industry, including banks. The Antwerp World Diamond Council (AWDC) has recently partnered with the GJEPC for its members to participate in the MyKYCBank.

Plans to introduce blockchain technology will also raise transparency by keeping a digital record of transactions made throughout a diamond's lifespan. De Beers has taken a lead in developing an open blockchain platform for the industry, while other groups, such as the AWDC, are also in talks to come on board. Similarly, programs such as the Gemological Institute of America (GIA)'s Mine-to-Market platform aim to make it easier to trace a diamond's journey along the distribution chain.

An illustration depicting diamond-smuggling activity in the Central African Republic. Global Witness commissioned the piece from an artist based in the country for its report on the subject.

IMAGE: Global Witness

REPUTATION MATTERS

These programs are essential to helping improve transparency. The jewelry supply chain is a complicated one, with raw materials — including diamonds, gold, platinum and other precious metals — coming from various locations around the world. Additionally, diamonds are an easily transportable product. They are vulnerable to abuse and misconduct, with suspicions still prevalent that they're widely used for the purposes of money laundering, terror financing, and fueling conflict in certain countries.

If these activities are still being carried out, it's by a small minority in the trade, but that tarnishes the reputation of the industry as a whole. Similarly, the odd high-profile bankruptcy garners much attention, even though the proportion of companies in liquidation is small relative to other industries.

The diamond trade has to be extra vigilant due to its unfortunate legacy of past dealings in such matters, and because diamonds, with their mystique and beauty, have a way of stirring the public's interest. The banks, along with social-action organizations and the media, are acutely aware of this and tend to harp on the negative.

CHANGE THE NARRATIVE

The diamond trade has made great strides in abandoning the informal business practices that made it susceptible to these issues. Tighter bookkeeping and reporting standards have led to a sharp reduction in cash transactions — as has legislation in countries such as India, where the demonetization program has influenced the formalization of the business sector, and small vendors are now required to open bank accounts and make electronic transactions.

Trade organizations are also working with bodies such as the Financial Action Task Force to dispel any misconceptions about their dealings and relay the reporting requirements to their members.

However, the industry often struggles to get its message across. It needs to dictate the narrative by demonstrating the positive developments it's undergone in improving transparency, as well as its contribution to society through so-called "diamonds do good" initiatives, according to Erik Jens, the former head of Dutch Bank ABN Amro's diamond and jewelry division. In a recent presentation, he suggested a centralized mapping of the initiatives within the trade that contribute to the UN's 17 sustainable-development goals.

Surrounded by negative noise, the banks want to know that their diamond clients make a positive contribution, have nothing to hide and maintain a healthy flow of orders. Such businesses will inevitably gain the support of the banks — but they need to prove their case consistently. ■

Varda Shine
Diamond business adviser and former De Beers executive

"The trade doesn't understand the financial market well enough, and it's fair to say the financial market is nervous about the diamond midstream"

IS THE DIAMOND TRADE OVER-FINANCED?

If you look at what the trade needs for buying rough and selling polished, it is probably slightly over-financed. But it doesn't always work like that, because when you polish a stone, you sometimes have to keep it in inventory for a period until there is demand.

The problem is that the midstream finances the entire industry. Producers sell rough for cash, and polished is sold on credit terms or sent on consignment. So the midstream has become the banking facility of the diamond pipeline.

IS THAT LIKELY TO CHANGE?

It will take a long time before the producers extend credit – if they ever will. It will only change if there is a serious liquidity crunch.

IS THAT LIQUIDITY CRUNCH NOT ALREADY HAPPENING?

I don't think so. While there are banks that are pulling away from the industry, there are also companies coming in that will fill that void. There are diamantaires that will lend to their peers, and we're seeing more money from other sources. It all adds up.

The issue for me is the tiering-up of diamantaires. The bigger, better companies won't have a problem getting finance, and the small guys are flexible [enough] to be efficient when they need to be. The question is what's going to happen to the middle. The middle is at risk of disappearing.

HOW IS THE RELATIONSHIP BETWEEN THE INDUSTRY AND THE BANKS?

The trade doesn't understand the financial market well enough, and it's fair to say the financial market is nervous about the diamond midstream. There's a discomfort about funding the midstream. The diamond trade is adapting to the financial world's requirements, but it's happening very slowly.

IS THE INDUSTRY'S HIGH-RISK PROFILE JUSTIFIED?

I don't think there have been more bankruptcies in the diamond trade than other industries. But diamantaires are traders, who by nature tend to focus on the short term, whereas the financial world wants to see long-term planning.

Another risk factor is that there really is no collateral in the industry. Diamond inventory is very dynamic in terms of where it is located at any given time, so it's very difficult to collateralize.

The financial sector also looks at diamonds as an ex-growth business. In the past 15 years, polished wholesale purchases have fluctuated between $24 billion in a bad year and $26 billion in a good year, while other industries have doubled. So that's not very attractive to a financier.

However, the financial sector does work with regulated industries as long as it can make proper returns. So the ball is in the trade's court. The industry needs to be more transparent and efficient. The more transparent it becomes, the better chance it will be funded. The more efficient it becomes, the less outside funding it's going to need. ■

Howard Davies
Vice president of commercial development at De Beers

"Once midstream diamond businesses can show their funders a normal corporate structure and normal financial reporting, there's no reason why they shouldn't be able to access normal corporate finance"

HOW DO YOU ASSESS THE CURRENT "BANKABILITY" OF THE DIAMOND MIDSTREAM?

It's continued to improve. Once midstream diamond businesses can show their funders a normal corporate structure and normal financial reporting, there's no reason why they shouldn't be able to access normal corporate finance.

I'm encouraged by growth in the midstream's use of structured finance products this year — that is, bonds and securitizations, which are funded mainly by capital-market investors. To participate in this kind of instrument, businesses need to be completely open with their investors, which is what more businesses are electing to do. The reward is the ability to access long-term finance, which can significantly strengthen a business's funding portfolio.

WHAT IS THE TIMELINE FOR SIGHTHOLDERS TO MEET INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)?

A healthy majority are already compliant, and others are fast approaching full compliance as we get nearer to the deadline. This year will be crucial. All financial statements for reporting years that begin on or after January 1, 2017, need to be fully compliant with the new requirements. So the deadline will be slightly different for individual businesses, depending on when their financial years begin.

WHAT HAVE BEEN THE BIGGEST CHALLENGES IN GETTING SIGHTHOLDERS TO BE MORE COMPLIANT?

Harmonizing De Beers' requirements with national tax-reporting standards has been one of the main things we've had to work hard to achieve. Allowing the new fiscal arrangements in Israel and Antwerp to be implemented, as well as India's goods and services tax (GST), was a key reason we extended the compliance timeline by 12 months.

Every business has its own unique challenges. However, one common theme has been the complexity of the corporate reorganization that's been needed to achieve IFRS compliance.

Developing a common best-practice approach around issues like inventory valuation and cost allocation for the auditing community was also a challenge but hugely valuable. This was difficult and groundbreaking work, which led to the Belgian Institute of Auditors publishing a set of best-practice guidelines for auditing midstream diamond businesses — something we couldn't have dreamed of five years ago. ■

Ernie Blom
President of the World Federation of Diamond Bourses (WFDB)

"The diamond trade is the best example of a self-regulated industry"

HOW IS THE DIAMOND INDUSTRY'S RELATIONSHIP WITH THE BANKING SECTOR?

It's still challenging because of misperceptions on the part of the banking community. That said…we're engaged in ongoing discussions to strengthen the links between us. In the vast majority of cases, the diamond business operates in a careful and measured manner.

WHAT DO BANKS NOT UNDERSTAND ABOUT THE DIAMOND TRADE THAT YOU WOULD LIKE THEM TO KNOW?

The banks think we're a high-risk industry. We need to continue to demonstrate that we're a well-run trade that operates according to modern business standards. The diamond trade is the best example of a self-regulated industry.

We are absolutely opposed to money laundering and terror financing, and work as part of the World Diamond Council (WDC) in the Kimberley Process Certification Scheme to fight conflict diamonds. We maintain strong relations with the Organization for Economic Cooperation and Development (OECD) and the Financial Action Task Force (FATF), where we demonstrate zero tolerance for fraudulent or any other illegal activity.

IS THERE SUFFICIENT LIQUIDITY IN THE DIAMOND MIDSTREAM?

There is a need for more liquidity. The midstream has been squeezed for some time and is operating on very slim margins. However, I am hopeful that the work of the Diamond Producers Association will stimulate greater consumer demand for diamond jewelry and that will in turn benefit the rest of the pipeline.

WHAT MUST THE TRADE DO TO IMPROVE CONFIDENCE AMONG BANKERS?

We are working to create a more corporate environment within the trade. Diamond companies are on board, but the banks see the trade as high-risk. This is unfair because we operate in a prudent way, and have done so since the 2008 financial crisis led the industry to change the way it operates.

The banks can also look at specific diamond centers, such Israel and Belgium, for changes in taxation policy that are raising transparency levels and providing assurance that the trade is a deserving recipient of credit.

These tax-policy decisions were made possible because the diamond trade was open in its negotiations. Since diamantaires are now in compliance with international financial reporting guidelines, the risk factor for banks has been reduced. This should serve to increase the trade's creditworthiness. ■

THE BANKING CENTERS

Diamantaires in Antwerp, Ramat Gan and New York have long pointed to their counterparts in Mumbai as having an unfair advantage. The Indian banks support the trade, as the government provides incentives to lend to export-focused industries.

Since the diamond industry is classified as a priority export sector, the banks in India can offer it credit at a discounted rate. That has provided the local trade with liquidity other centers didn't have after the 2008 crisis, and enabled Indian manufacturers to gain significant market share in the past decade.

The perception is that a lot of banks in India got involved with diamond businesses so they could satisfy their priority-lending requirements, but didn't necessarily have a solid comprehension of the market. Today, there are 40 to 60 banks lending to the diamond trade in India.

But it's not as easy to secure funding as it used to be. Dealers note that the Indian banks have started to emulate their Western counterparts' tighter lending requirements in light of some high-profile defaults in the past few years. At the same time, as one Mumbai-based supplier points out, there are certain government-owned banks financing the trade in India that have a different way of working than private-sector institutions, with their own set of criteria and procedures. If you know the process, it's relatively easy to get financing.

Each diamond center has its advantages and disadvantages. A number of banks in Israel left the trade over the past decade, the most recent instance being Bank Leumi shutting its branch in the bourse. The result is that bank credit in Israel has fallen from around $2.5 billion before the financial crisis to less than $1 billion today. The recent merger between Bank Mizrahi and Union Bank — two of the larger diamond lenders — may cause some further realignment. But overall, the industry has arguably emerged more efficient and self-sufficient, with less reliance on the banks.

Belgium is going through a similar process following the closure of Antwerp Diamond Bank and Standard Chartered Bank, and diamantaires have even had difficulty procuring personal credit due to their association with the trade. Other centers, such as Dubai, are trying to capitalize on Antwerp's banking-sector caution, targeting the Belgian trade's clients in the hope of gaining market share.

However, Antwerp has an opportunity to maintain its status as the leading financial center for the diamond industry, as it is best positioned to work with financial institutions to get alternative financing options, such as inventory or receivables securitization. ■

LONG-TERM ALTERNATIVES

The capital markets are providing an alternative source of funding to diamond companies that have the scale and efficiency to work in such an environment.

The financial instruments on offer are typically for longer terms than bank loans, extending over three to five years. They also expose the borrower to a different type of funding body, such as a capital markets investor, an insurance company or a pension fund. Those financiers are not bound by the stringent Basel regulations that govern the banking sector, so they're less likely to share the banks' reluctance to fund the diamond industry. Also, because of the long-term nature of these arrangements, the diamantaire is protected from losing its financing if the diamond market takes a downturn.

One such financing option is securitization, in which a diamantaire issues a bond note (or debt placement) that a third-party funder purchases. The value of the bond's collateral — which can be either the diamond company's inventory or its trade receivables (orders), or both — must remain at a certain level, while the bond is issued at a fixed rate of interest and rated by an outside agency.

While these funding bodies are not subject to the Basel regulations, they have their own set of rules and requirements. Diamantaires must be completely open and transparent, have proper procedures in place, be good at explaining their business, have a good reputation, and reliably send in the required reports and invoices on time, explains one financier involved with alternate funding sources. ■

IMAGE: Antwerp Diamond Fair

MARKET ANALYSIS
POLISHED

Polished-diamond trading stabilized in December and January, driven by last-minute orders for the Christmas and Chinese New Year holidays, and shortages due to limited manufacturing.

Prices firmed, with the RapNet Diamond Index (RAPI™) for 1-carat diamonds up 0.3% in December and a further 1.4% from January 1 to press time on January 21. RAPI for 0.30-carat diamonds increased 2.6% over that 52-day period (December 1 to January 21), while 0.50-carat stones rose 2.2%. RAPI for 3-carat stones declined 0.8% during the period (see graph).

There are fewer goods on the market, as manufacturers in India have maintained lower factory output since Diwali, and as dealers in Antwerp and New York were on vacation during the Christmas and New Year holidays.

The number of diamonds listed on RapNet declined 13% from December 1 to January 21, when there were 1.18 million unique stones (see graph).

Market sentiment improved, with dealers optimistic for 2018, following positive reports about the US holiday season. Some were waiting to see how many of the goods they had sent out on memo would return, before assessing the holiday season; they will have a better sense in the coming weeks. Chinese demand has also been steady as jewelers prepare for the Chinese New Year, which starts on February 16. Rapaport expects polished prices to remain firm throughout the first quarter, with jewelers replenishing stock they sold during the holiday season.

KEY MARKET TRENDS

United States: Market improving, with positive outlook for 2018 due to strong economy, rising stock market and tax cuts.

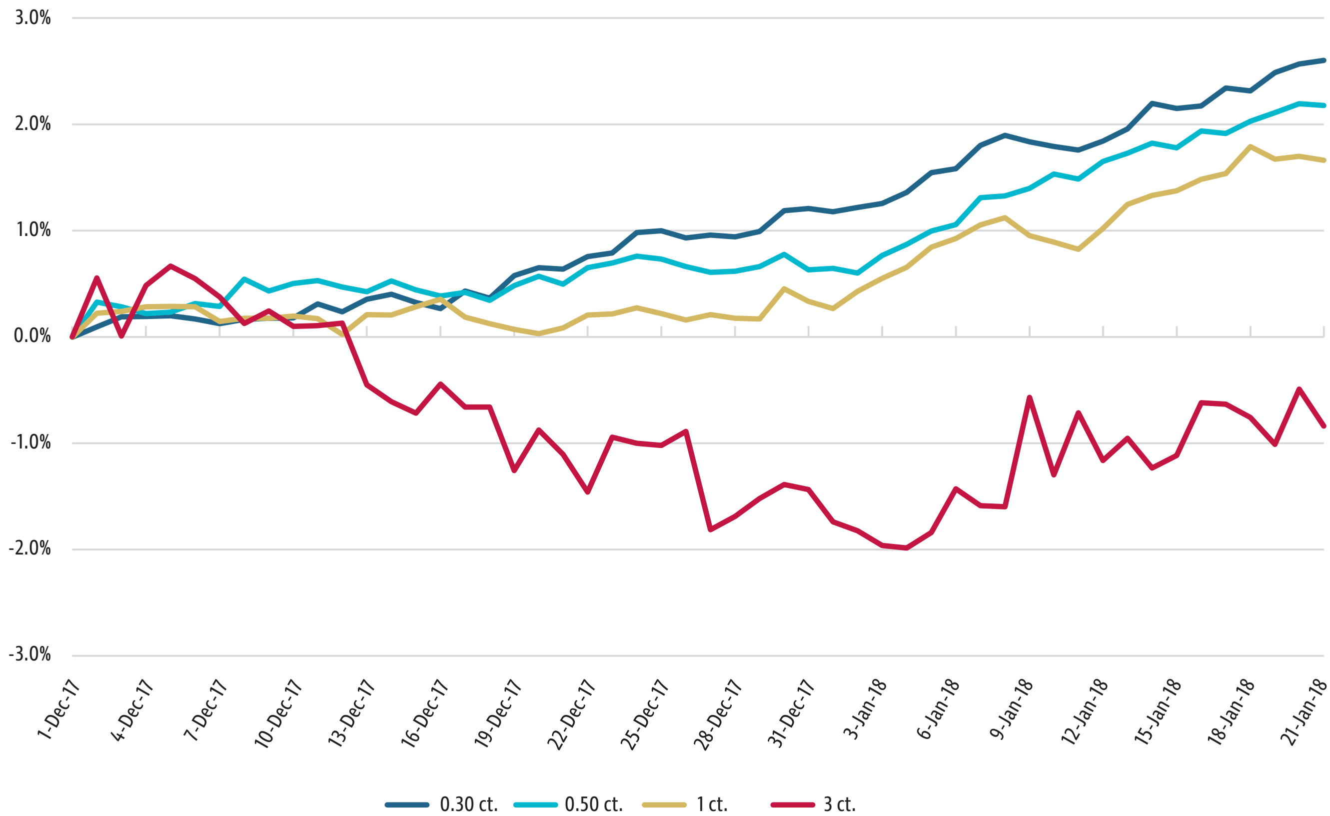
Belgium: Trading has resumed after Christmas-New Year break, with dealers in optimistic mood. Dealers expecting robust post-holiday US orders.

Israel: Improved profit for dealers and manufacturers compared to before the holiday season. Bourse announces diamond-backed cryptocurrency to launch at International Diamond Week, which begins in Ramat Gan on February 5.

India: December-January trading relatively quiet with US and European dealers out of the market. Focus has shifted to filling Chinese New Year orders.

Hong Kong: Trading quieter than before Christmas. Positive outlook for Chinese New Year, with renewed jewelry retail growth in mainland China and Hong Kong/Macau. ■

RAPNET DIAMOND INDEX (RAPI™)



The RapNet Diamond Index (RAPI™) is the average asking price in hundred $/ct. of the 10% best-priced diamonds, for each of the top 25 quality round diamonds (D-H, IF-VS2, GIA-graded, RapSpec-A3 or better) offered for sale on RapNet – Rapaport Diamond Trading Network.

MARKET ANALYSIS
ROUGH

Rough trading was quiet in December and at the beginning of January. There were fewer goods on the market, as there was a relatively long wait between the two sales cycles. Rough demand was projected to rise at the Alrosa contract sale and De Beers sights — which occurred in late January during or after press time — since polished inventories diminished over the holiday season.

Manufacturers have maintained factory operations at an estimated 60% to 80% of full capacity, particularly among the smaller companies. That has led to pent-up demand for rough, and a firming of prices on the dealer market.

Mining companies saw lower sales in 2017 due to a drop in the average price of goods sold, and despite an increase in the volume of rough they produced. There was a rise in demand for smaller and lower-quality goods throughout the year, after manufacturers avoided those goods in late 2016 due to squeezed liquidity following the Indian government's demonetization program.

De Beers' rough sales fell 5% to $5.3 billion for the year, while Alrosa's rough sales declined 5% to $4.27 billion, according to Rapaport projections.

One exception was Botswana's parastatal Okavango Diamond Company, which gets 15% of production through Debswana, the joint mining venture between the government and De Beers. Okavango's rough sales increased 4% to $567 million in 2017, its highest level since launching sales in 2013. The company's average price grew 5% to $166 per carat.

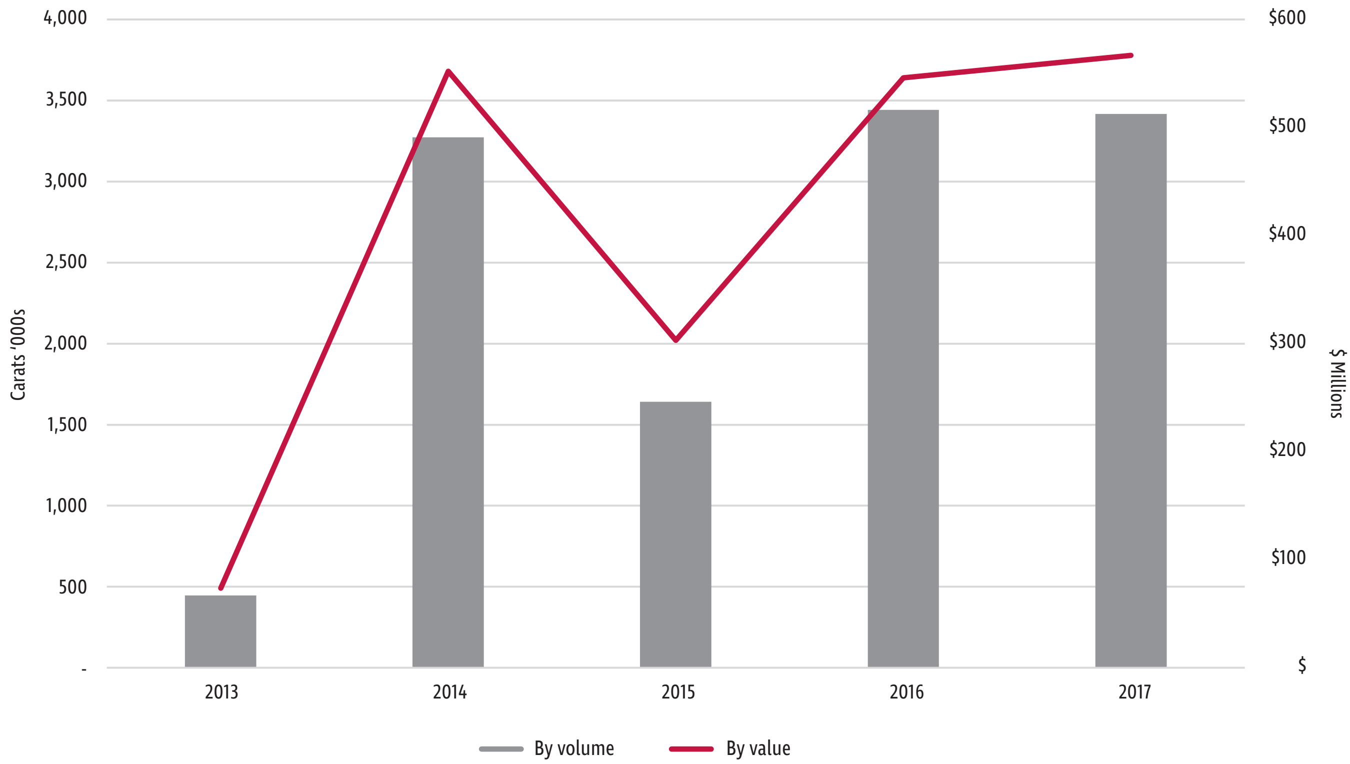
Okavango is important because it provides a window into De Beers' production, since Debswana makes up approximately two-thirds of De Beers' rough output.

While De Beers is notoriously guarded about publishing detailed sales and pricing information, Okavango publishes the results of its 10 annual auction sales. Its top five single-stone lots in 2017 were:

	Size	Sales price	Price per carat
1.	155.07 ct.	$7,551,907	$48,700/ct.
2.	151.84 ct.	$7,068,911	$46,555/ct.
3.	101.44 ct.	$4,361,920	$43,000/ct.
4.	92.63 ct.	$4,029,405	$43,500/ct.
5.	29.58 ct.	$3,653,130	$123,500/ct.

Rapaport expects a buoyant rough market in the first quarter of 2017, as manufacturers' polished inventory has been depleted and they need stock to fill retailers' orders after a solid holiday season. ■

OKAVANGO DIAMOND COMPANY SALES



Based on data from Okavango Diamond Company and Rapaport estimates.

RETAIL

The positive sentiment across the diamond supply chain stemmed from good sales during the US holiday season. Renewed growth in China and Hong Kong is also fueling optimism ahead of the Chinese New Year, which begins on February 16.

Most US retailers reported a favorable season, which was encouraging given that 2017 was a tough year for brick-and-mortar retail. Faced with the rise of e-commerce, declining mall traffic and a trend among millennials to spend more on experiences than goods, the retail sector has come under pressure. However, the holiday-selling season proved strong as economic growth, tax cuts and record-high stock markets boosted consumer confidence. Overall, US jewelry sales grew 5.9% year on year during November and December, according to Mastercard SpendingPulse.

Macy's and J.C. Penney noted jewelry as a strong category (without providing hard data), while Tiffany outperformed among the specialty jewelers. Signet Jewelers' results disappointed, largely due to glitches in its credit program, which it recently sold to an outsourced provider.

The following tables break down the year-on-year performance of various Signet and Tiffany divisions for November and December. ■

Signet Jewelers			
	Same-store sales	**Total sales growth**	**Total sales***
Sterling Jewelers division			
Kay Jewelers	-10.8%	-8.8%	$723
Jared	-5.9%	-5.0%	$346
R2Net	38.6%	N/A	$51
Regional brands	-29.1%	-39.6%	$27
Zale division			
Zales Jewelers	4.6%	2.2%	$402
Gordon's Jewelers	-12.6%	-35.5%	$11
Peoples Jewellers	3.8%	5.8%	$66
Mappins	-14.5%	-44.4%	$5
Piercing Pagoda	4.9%	4.9%	$73
UK division			
H. Samuels	-10.2%	-3.9%	$95
Ernest Jones	-10.5%	-3.9%	$82
Other	N/A	-61.5%	$2
Total	**-5.3%**	**-3.1%**	**$1,882**

Tiffany & Co.			
	Same-store sales	Total sales growth	Total sales*
Americas	6%	7%	$516
Asia Pacific	7%	16%	$232
Japan	0%	1%	$145
Europe	2%	14%	$136
Other locations & wholesale	14%	-10%	$18
Total	**5%**	**8%**	**$1,047**

* Sales are in millions of dollars.

RAPAPORT DIAMOND PRICE ANALYSIS

OVERVIEW

Since 1976, the Rapaport Group has been committed to supporting the development of fair, transparent, efficient and competitive diamond and jewelry markets. As part of that mission, we are pleased to provide subscribers to the Rapaport Research Report with a monthly diamond price analysis that presents reliable and representative indicators of the state of the diamond market. All data is based on activity on Rapaport's electronic trading platform, RapNet. With around 1.2 million individual diamonds valued at over $7.4 billion, we believe activity on RapNet accurately reflects the diamond market as a whole.

METHODOLOGY

Data provided in the following pages of this report refers to GIA-graded round brilliant diamonds listed on RapNet that meet RapSpec A3 standards or better. The data reflects supply and demand trends across various color and clarity classifications in the 0.30-carat, 0.50-carat, 1-carat and 3-carat diamond size categories, for the most recent available reporting period. Comparisons for the stated period are made relative to the average of the previous three months. Country data is based on the listed location of eligible diamonds.

DEFINITIONS

Discount:

The difference between the average asking price on RapNet and the Rapaport Price List price, expressed as a percentage.

Inventory:

Quantity of individual diamonds listed on RapNet.

New inventory:

Diamonds newly listed on RapNet in September 2017.

Sales:

Diamonds that were removed from RapNet or that switched owners, provided the two companies are not known to be related.

RAPSPEC A3

Grading report	GIA
Shape	Round brilliant
Cut	Excellent
Polish	Excellent
Symmetry	Excellent
Culet	None
Depth %	58.5% to 62.7%
Table %	55% to 62%
Girdle	No Extremely Thin, Extremely Thick or Very Thick
Fluorescence	Faint blue allowed
Weight	No .00 sizes for 1.00 and larger
GIA comments	No GIA color comment No knot or cavity For SI1 or lower No "clarity based on cloud"
Seller requirement	No green tint No Marange diamonds

RAPAPORT DIAMOND PRICE ANALYSIS

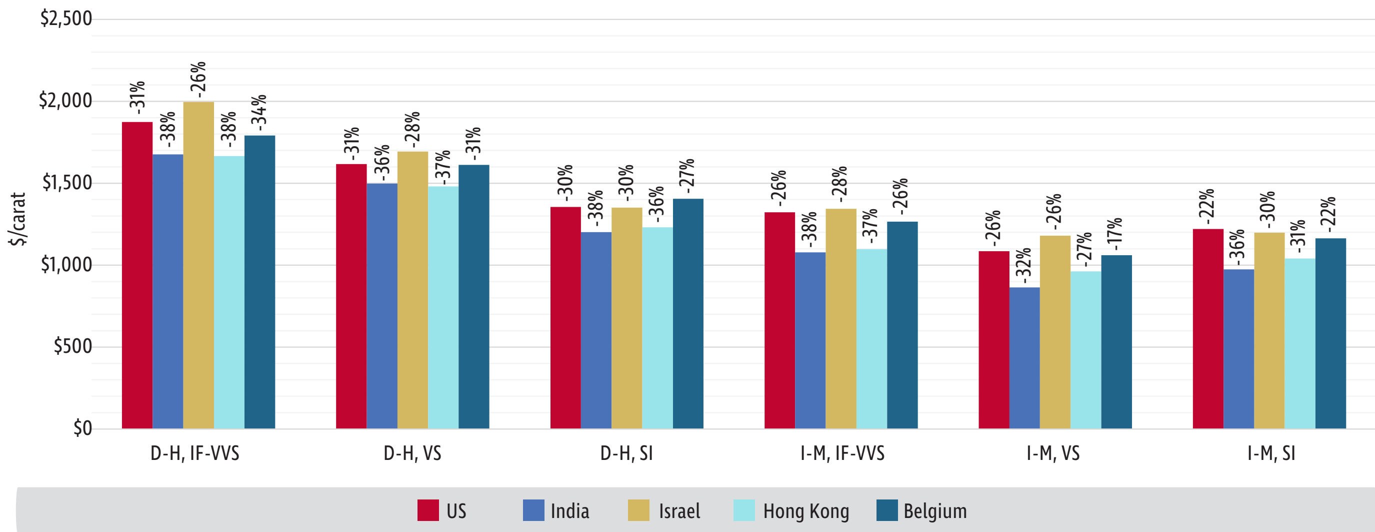
0.30 ct. SUPPLY

Snapshot for December 2017 — All changes are for December compared to the average of the previous three months.

		IF-VVS	VS	SI
Discount	D-F	39%	38%	40%
Price change	D-F	1.4%	0.8%	0.0%
Inventory change	D-F	-13.6%	-30.6%	-24.7%
Discount	G-H	38%	33%	35%
Price change	G-H	0.8%	1.2%	0.2%
Inventory change	G-H	-27.2%	-24.3%	-19.8%
Discount	I-K	39%	35%	34%
Price change	I-K	0.5%	0.6%	-0.4%
Inventory change	I-K	-29.6%	-34.4%	-13.3%
Discount	L-M	37%	37%	30%
Price change	L-M	0.1%	-0.5%	-1.9%
Inventory change	L-M	18.7%	11.4%	7.4%

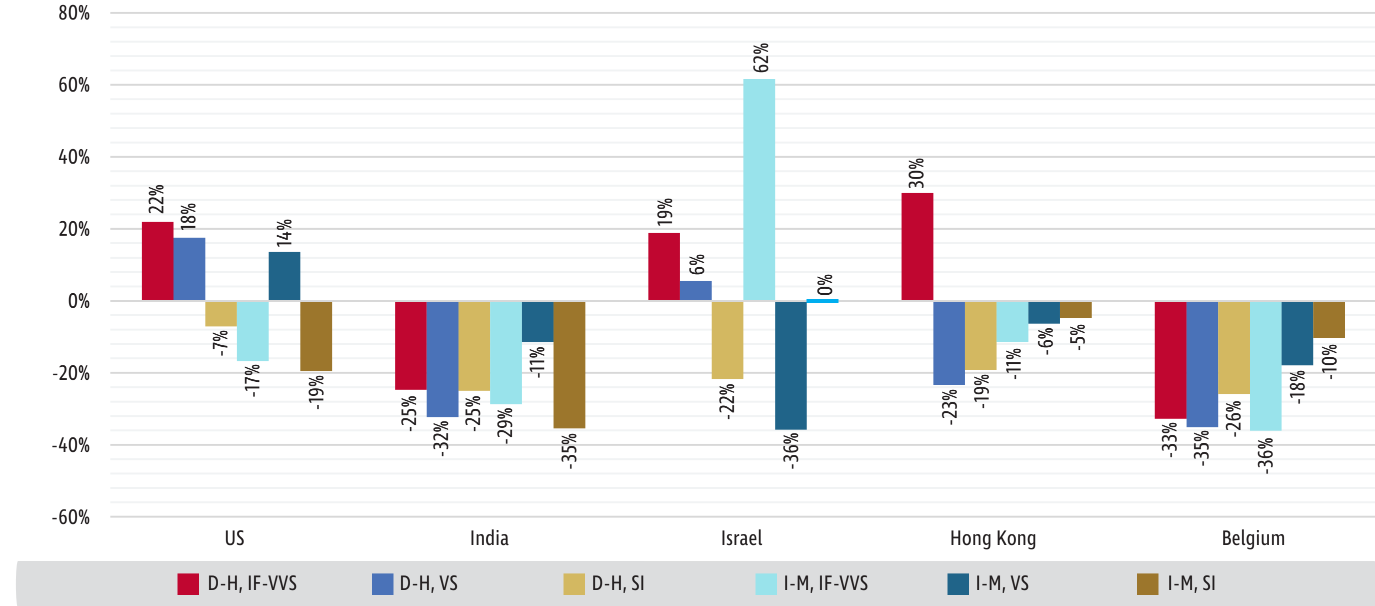
Average asking price by country in December 2017

Percentage reflects average discount to the Rapaport Price List in December.



Change in inventory by country

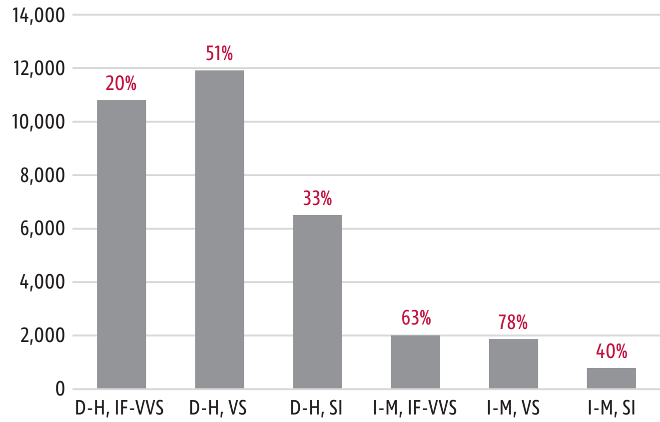
Percentage reflects change in inventory during December compared to the average of the previous three months.



RAPAPORT DIAMOND PRICE ANALYSIS

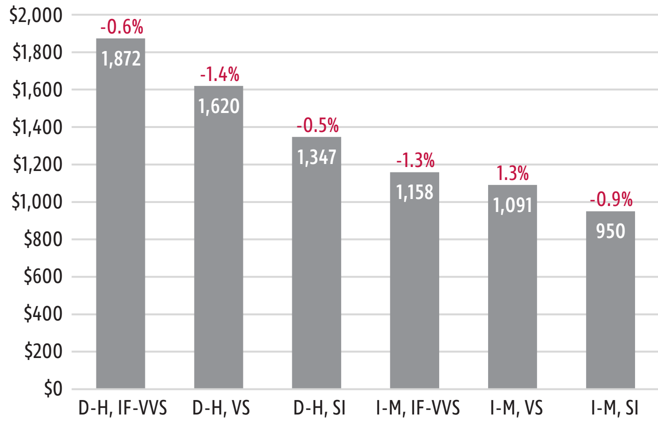
0.30 ct. DEMAND

Volume of sales in November 2017



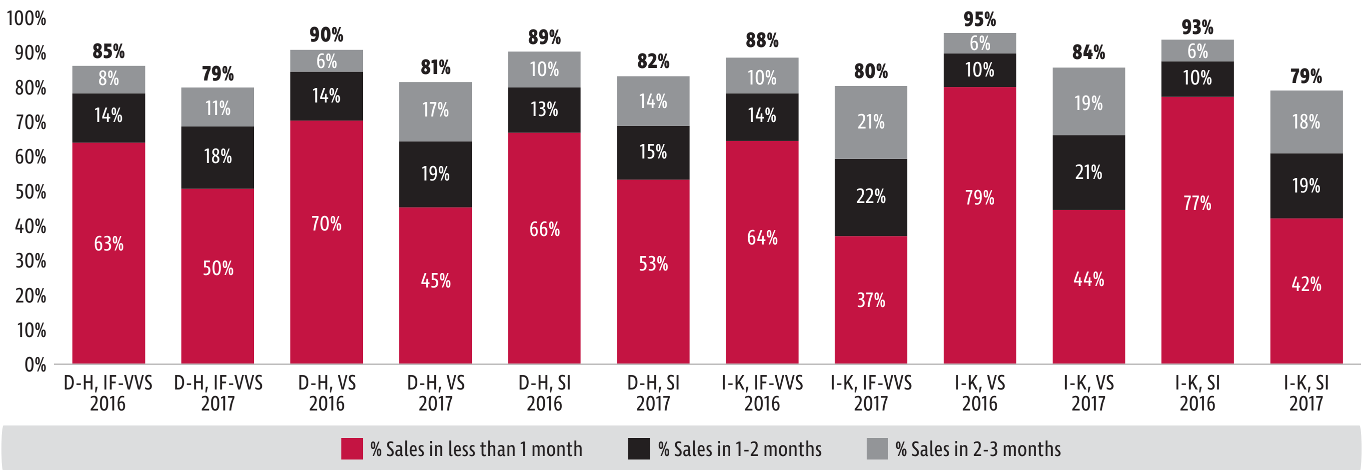
Percentage reflects the change in the quantity of diamonds sold during November relative to the average of the previous three months.

Average sales price in November 2017



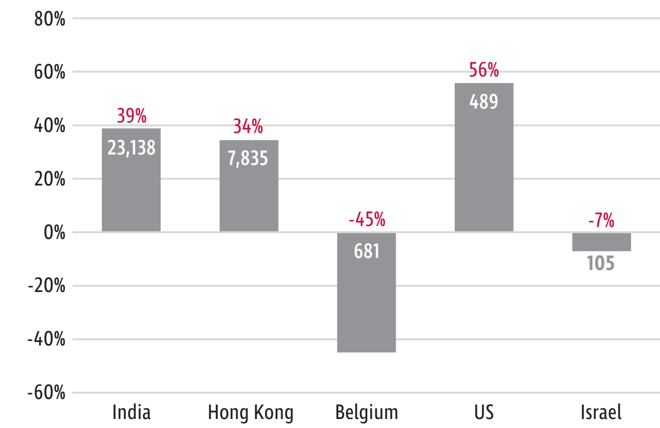
Percentage reflects the change in the average asking price during November compared to the average of the previous three months.

Average time to sale of new inventory listed on RapNet in September



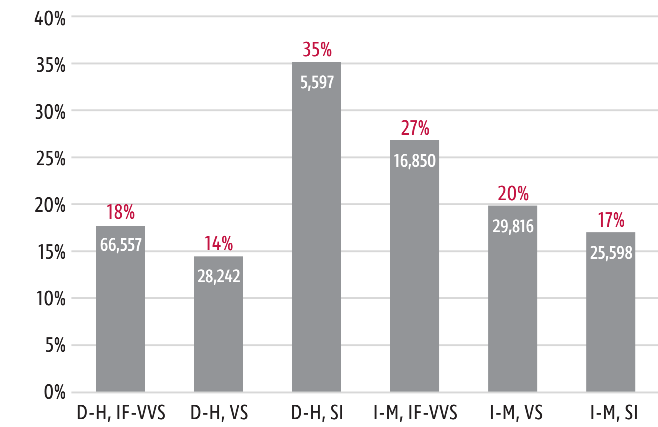
Percentages represent the proportion of diamonds that entered the RapNet list in September 2016 and 2017 and sold within three months.

Growth in no. of sales by country in November 2017



Percentages represent the change in number of sales during November compared to the average of the previous three months.

Change in search volume in December 2017



Percentages reflect the change in the number of searches during December compared to the average of the previous three months.

RAPAPORT DIAMOND PRICE ANALYSIS

0.50 ct. SUPPLY

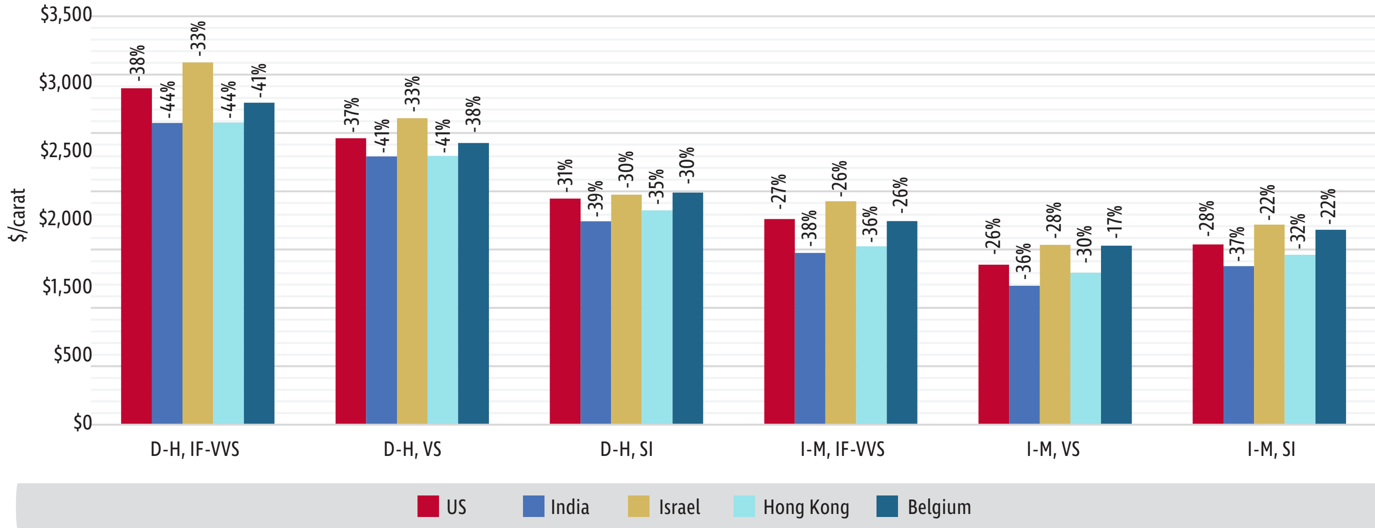
Snapshot for December 2017

All changes are for December compared to the average of the previous three months.

		IF-VVS	VS	SI
Discount	D-F	45%	42%	39%
Price change	D-F	-0.5%	0.3%	1.4%
Inventory change	D-F	-30.2%	-27.3%	-29.2%
Discount	G-H	42%	37%	35%
Price change	G-H	0.9%	-0.3%	1.8%
Inventory change	G-H	-31.1%	-30.2%	-20.4%
Discount	I-K	40%	37%	37%
Price change	I-K	1.6%	1.3%	-0.2%
Inventory change	I-K	-36.0%	-15.1%	-19.0%
Discount	L-M	39%	39%	36%
Price change	L-M	0.1%	1.8%	2.1%
Inventory change	L-M	-5.6%	-15.9%	-8.4%

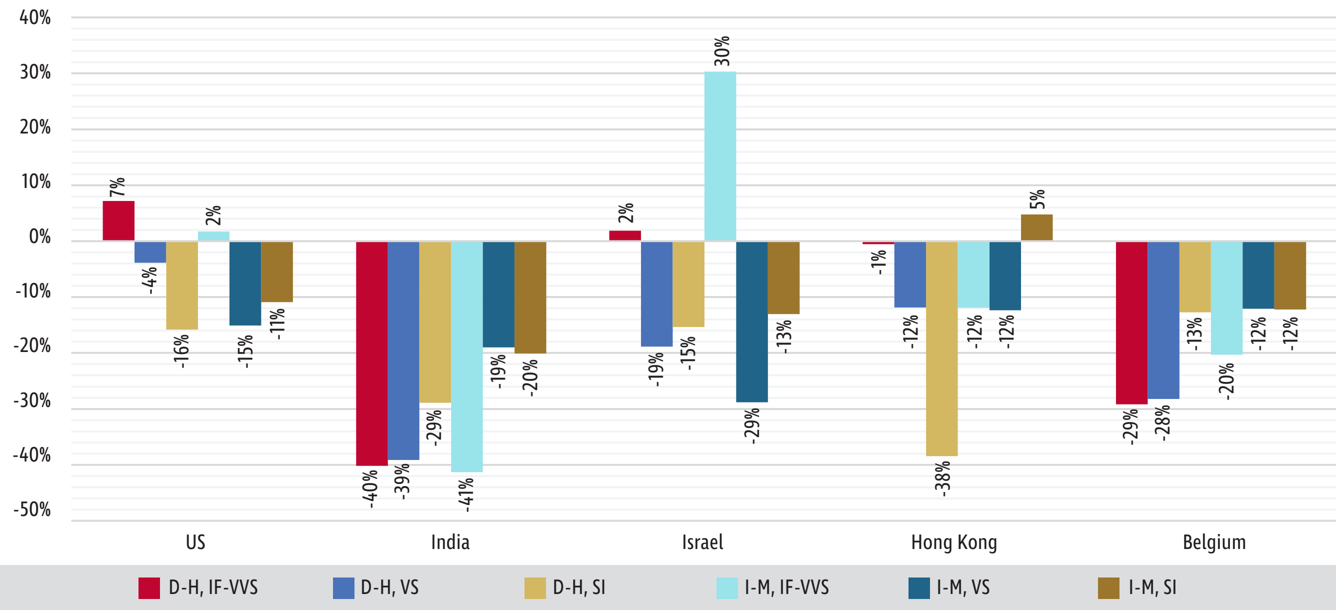
Average asking price by country in December 2017

Percentage reflects average discount to the Rapaport Price List in December.



Change in inventory by country

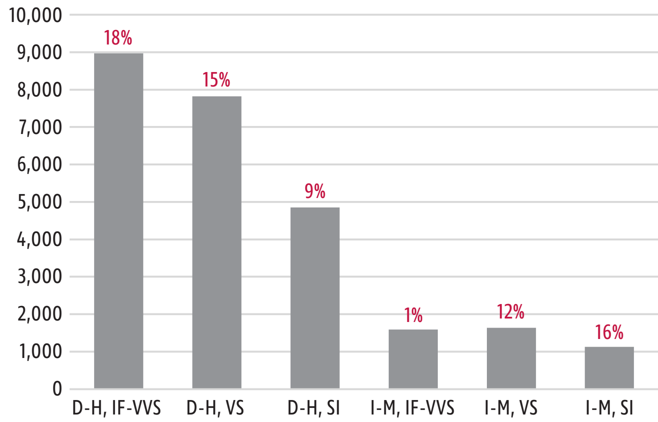
Percentage reflects change in inventory during December compared to the average of the previous three months.



RAPAPORT DIAMOND PRICE ANALYSIS

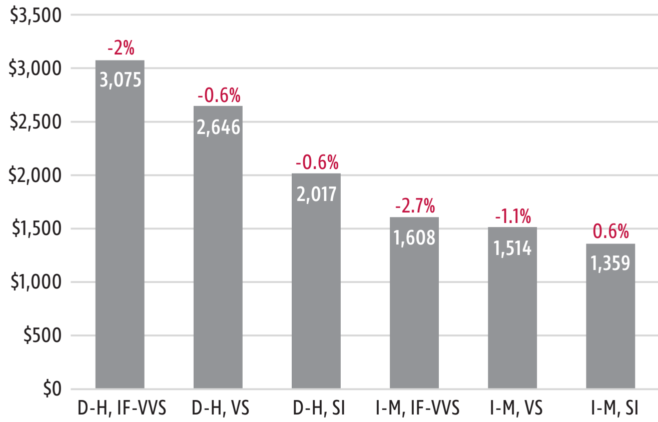
0.50 ct. DEMAND

Volume of sales in November 2017



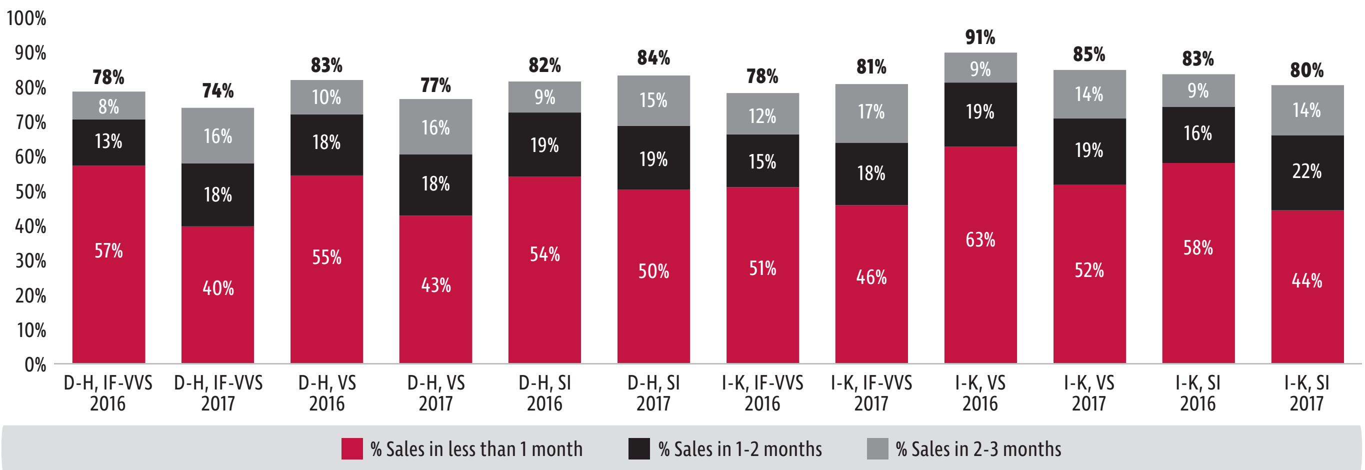
Percentage reflects the change in the quantity of diamonds sold during November relative to the average of the previous three months.

Average sales price in November 2017



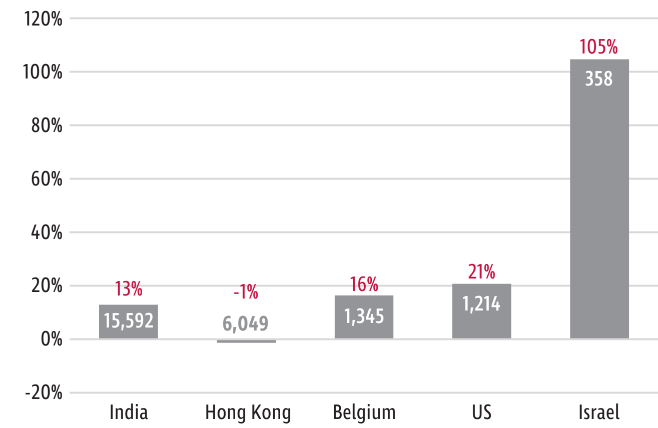
Percentage reflects the change in the average asking price during November compared to the average of the previous three months.

Average time to sale of new inventory listed on RapNet in September



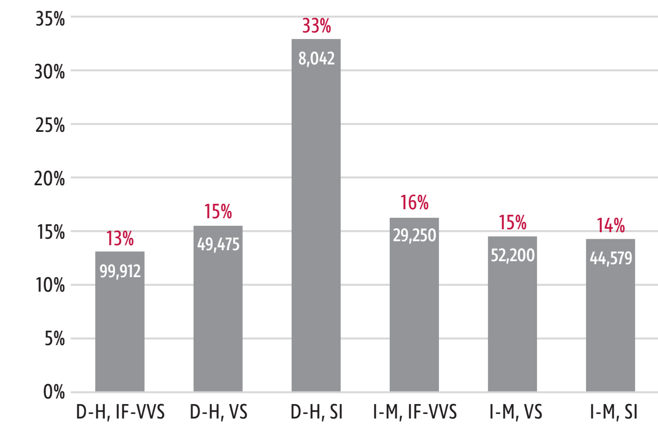
Percentages represent the proportion of diamonds that entered the RapNet list in September 2016 and 2017 and sold within three months.

Growth in no. of sales by country in November 2017



Percentages represent the change in number of sales during November compared to the average of the previous three months.

Change in search volume in December 2017



Percentages reflect the change in the number of searches during December compared to the average of the previous three months.

RAPAPORT DIAMOND PRICE ANALYSIS

1 ct. SUPPLY

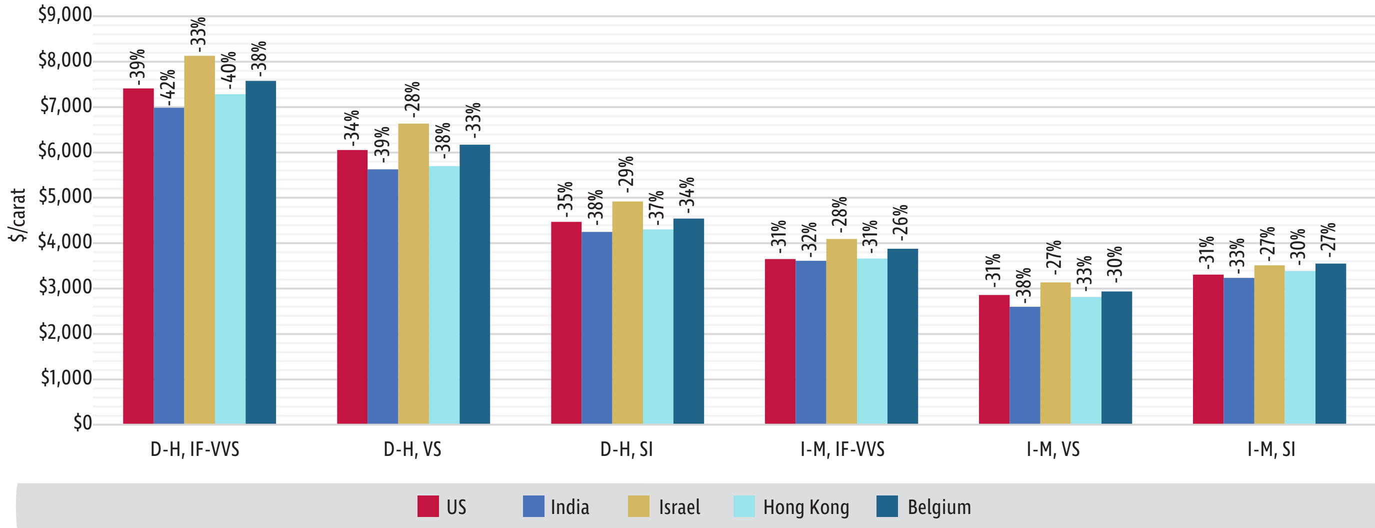
Snapshot for December 2017

All changes are for December compared to the average of the previous three months.

		IF-VVS	VS	SI
Discount	D-F	42%	39%	37%
Price change	D-F	-0.9%	-0.6%	1.2%
Inventory change	D-F	-13.7%	-15.8%	-11.9%
Discount	G-H	40%	34%	37%
Price change	G-H	0.4%	0.4%	0.4%
Inventory change	G-H	-12.2%	-15.2%	-12.0%
Discount	I-K	37%	35%	38%
Price change	I-K	1.7%	2.2%	1.0%
Inventory change	I-K	-17.6%	-14.1%	-16.3%
Discount	L-M	32%	35%	36%
Price change	L-M	7.9%	6.1%	7.1%
Inventory change	L-M	-17.5%	-12.1%	-22.0%

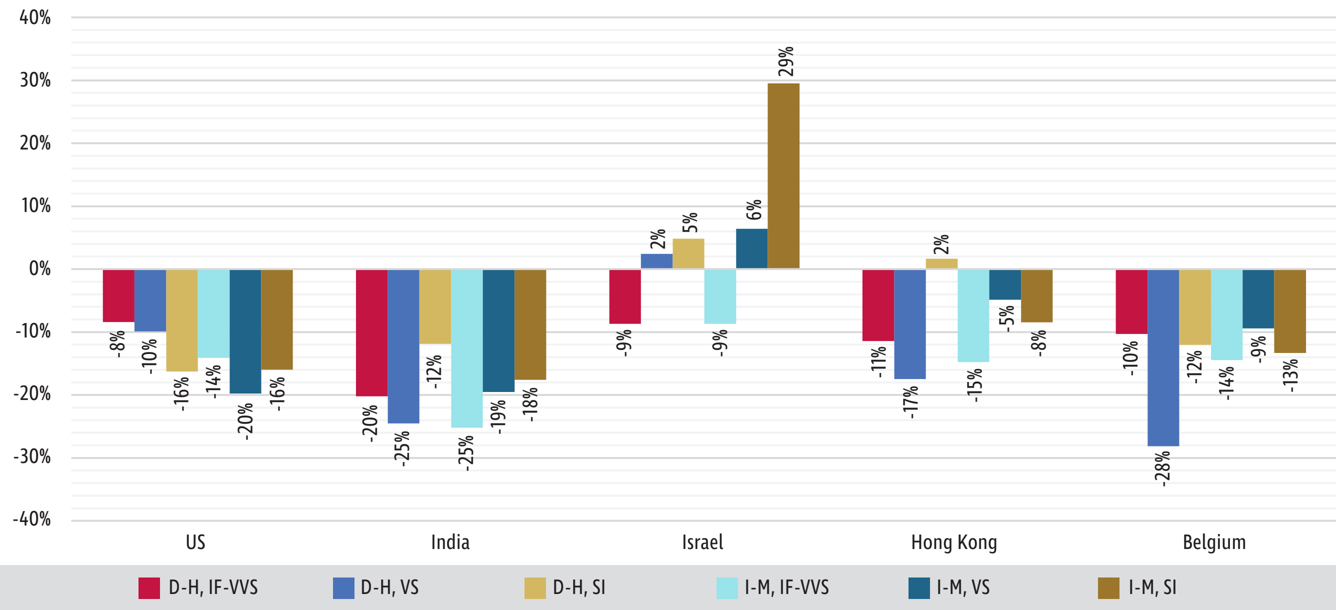
Average asking price by country in December 2017

Percentage reflects average discount to the Rapaport Price List in December.



Change in inventory by country

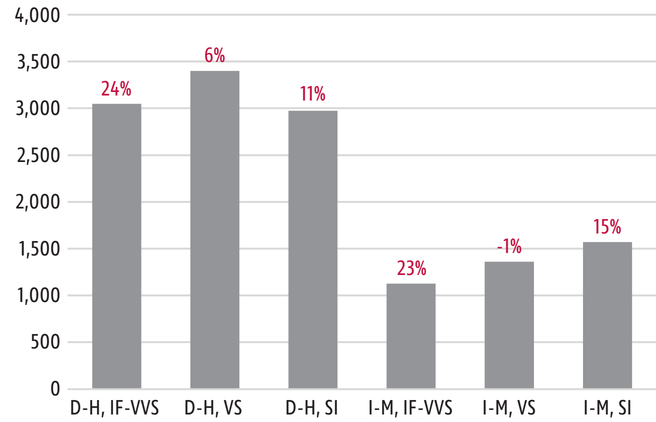
Percentage reflects change in inventory during December compared to the average of the previous three months.



RAPAPORT DIAMOND PRICE ANALYSIS

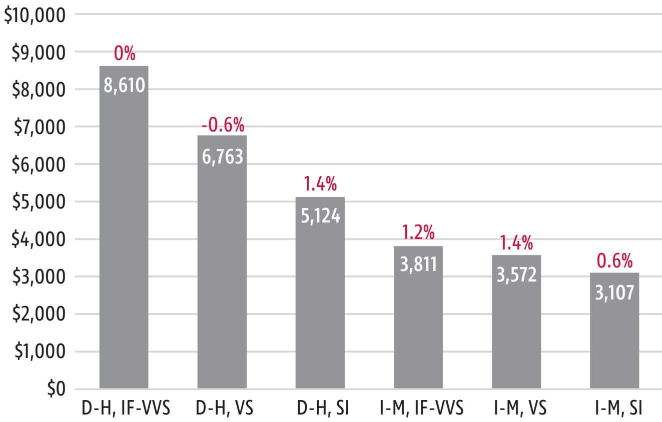
1 ct. DEMAND

Volume of sales in November 2017



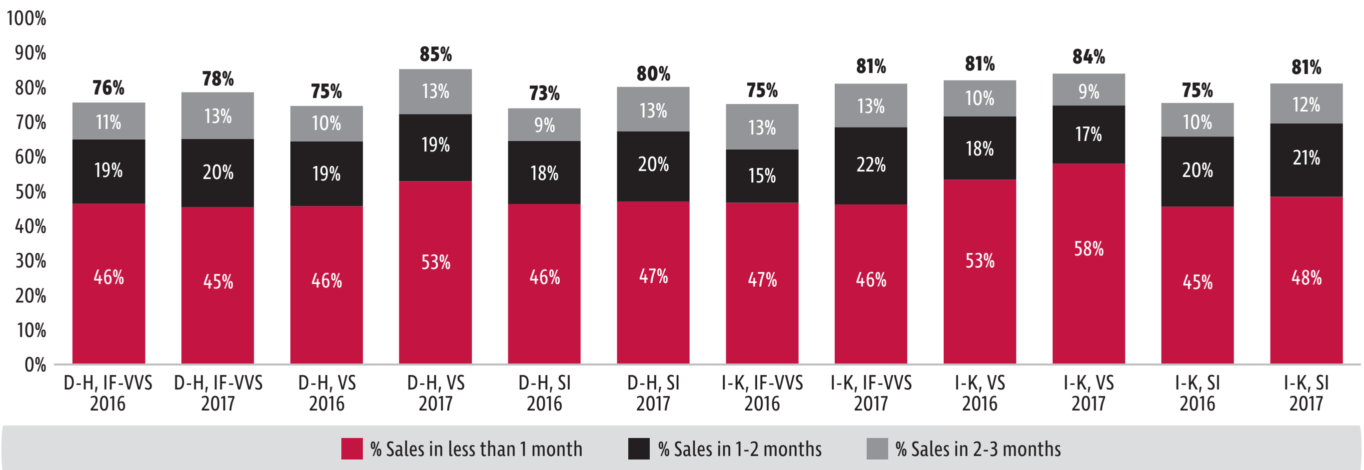
Percentage reflects the change in the quantity of diamonds sold during November relative to the average of the previous three months.

Average sales price in November 2017



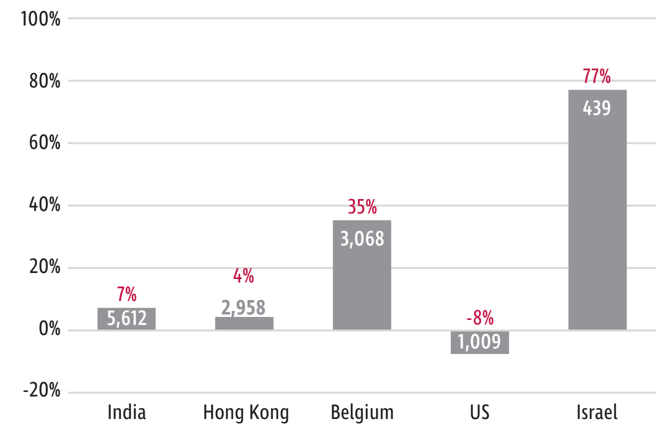
Percentage reflects the change in the average asking price during November compared to the average of the previous three months.

Average time to sale of new inventory listed on RapNet in September



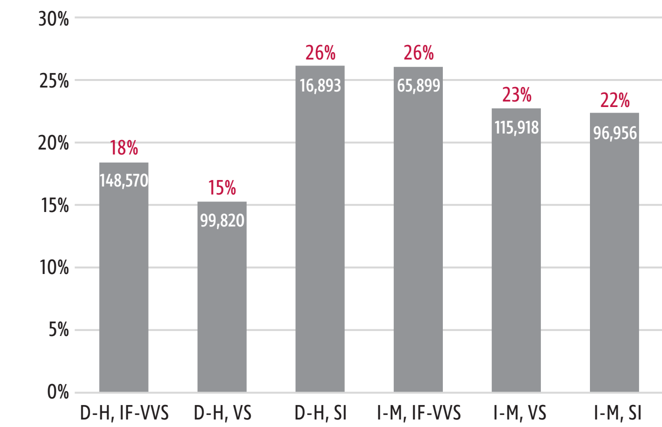
Percentages represent the proportion of diamonds that entered the RapNet list in September 2016 and 2017 and sold within three months.

Growth in no. of sales by country in November 2017



Percentages represent the change in number of sales during November compared to the average of the previous three months.

Change in search volume in December 2017



Percentages reflect the change in the number of searches during December compared to the average of the previous three months.

RAPAPORT DIAMOND PRICE ANALYSIS

3 ct. SUPPLY

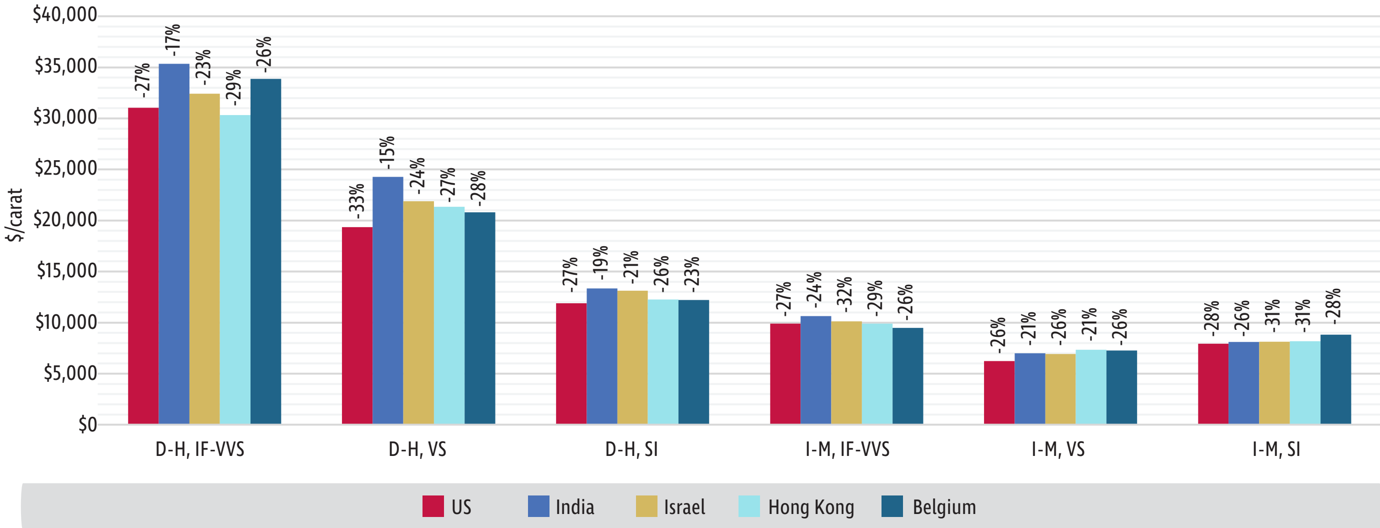
Snapshot for December 2017

All changes are for December compared to the average of the previous three months.

		IF-VVS	VS	SI
Discount	D-F	34%	35%	29%
Price change	D-F	-2.7%	1.1%	0.8%
Inventory change	D-F	10.8%	-4.3%	-11.8%
Discount	G-H	33%	35%	33%
Price change	G-H	-1.3%	0.6%	1.4%
Inventory change	G-H	-5.5%	-10.2%	-15.5%
Discount	I-K	31%	36%	34%
Price change	I-K	-0.5%	0.9%	3.6%
Inventory change	I-K	-18.0%	-9.7%	-17.0%
Discount	L-M	29%	31%	23%
Price change	L-M	-2.7%	1.1%	2.3%
Inventory change	L-M	-23.9%	-11.1%	-25.9%

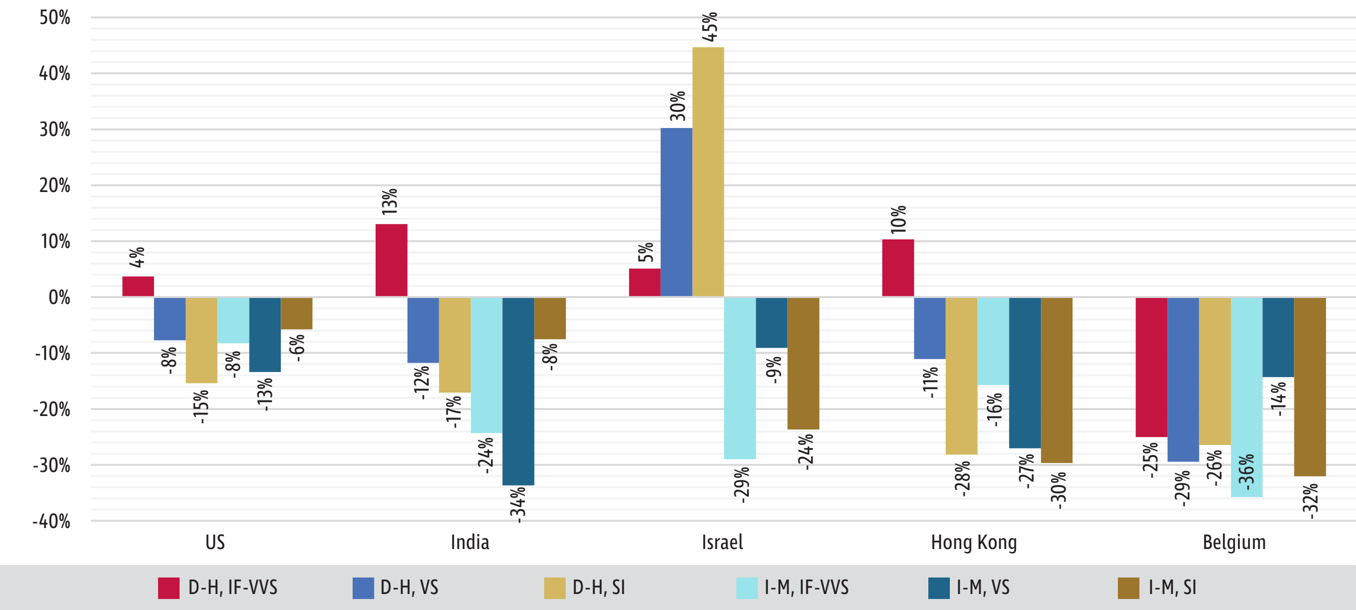
Average asking price by country in December 2017

Percentage reflects average discount to the Rapaport Price List in December.



Change in inventory by country

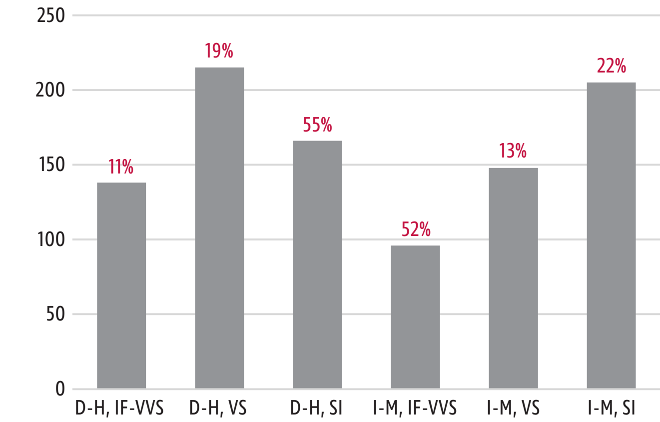
Percentage reflects change in inventory during December compared to the average of the previous three months.



RAPAPORT DIAMOND PRICE ANALYSIS

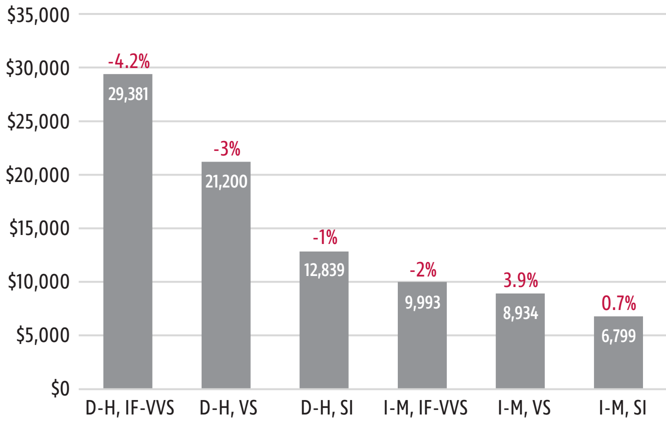
3 ct. DEMAND

Volume of sales in November 2017



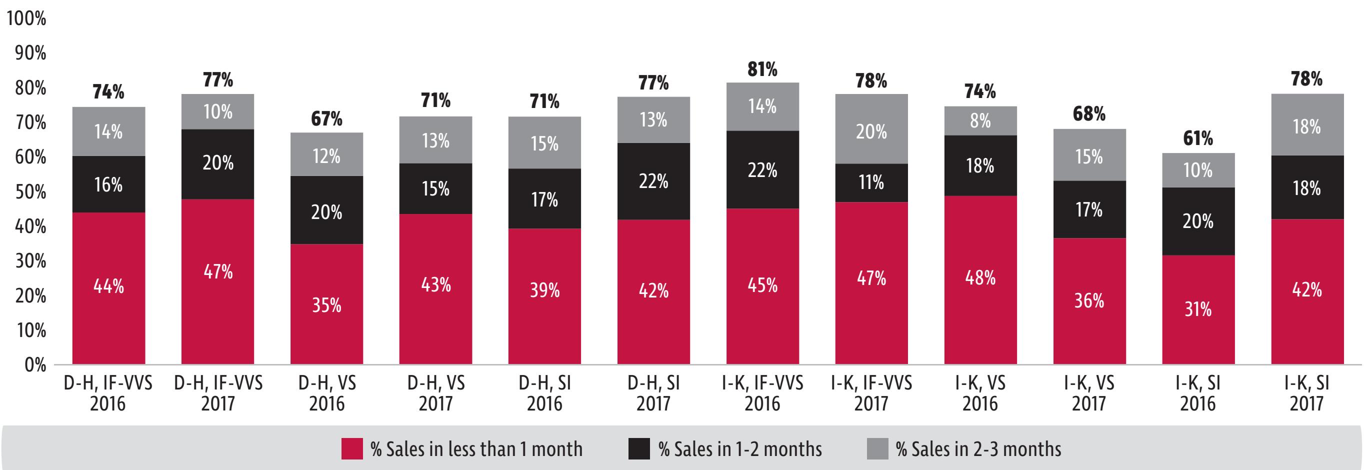
Percentage reflects the change in the quantity of diamonds sold during November relative to the average of the previous three months.

Average sales price in November 2017



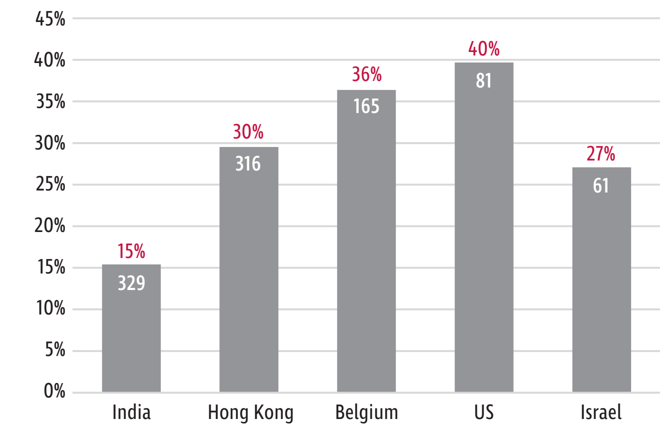
Percentage reflects the change in the average asking price during November compared to the average of the previous three months.

Average time to sale of new inventory listed on RapNet in September



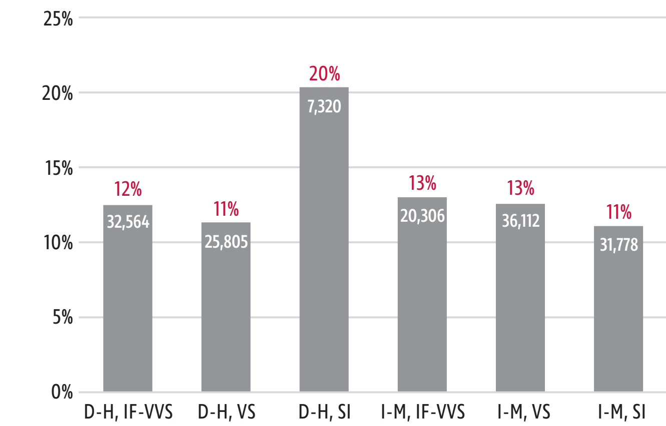
Percentages represent the proportion of diamonds that entered the RapNet list in September 2016 and 2017 and sold within three months.

Growth in no. of sales by country in November 2017



Percentages represent the change in number of sales during November compared to the average of the previous three months.

Change in search volume in December 2017



Percentages reflect the change in the number of searches during December compared to the average of the previous three months.

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RAPNET DIAMOND INDEX (RAPI™)

The RAPI is the average asking price in hundred $/ct. of the 10% best-priced diamonds, for each of the top 25 quality round diamonds (D-H, IF-VS2, GIA-graded, RapSpec-A3 and better) offered for sale on RapNet – Rapaport Diamond Trading Network. RapNet provides daily listings of approximately 1.2 million diamonds valued at over $7.4 billion.

Additional information is available at *RapNet.com*

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The Rapaport Group is an international network of companies providing added-value services that support the development of ethical, transparent, competitive and efficient diamond and jewelry markets. Established in 1976, the Group has more than 20,000 clients in over 121 countries. Group activities include Rapaport Information Services, providing the benchmark Rapaport Price List for diamonds, as well as research, analysis and news; RapNet – the world's largest diamond trading network, with over 15,000 members in 94 countries; Rapaport Laboratory Services, providing GIA and Rapaport gemological services in India, Israel and Belgium; and Rapaport Trading and Auction Services, the world's largest recycler of diamonds, selling over 500,000 carats of diamonds annually.

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