The Golan Diamond Market Report

Q3 2019

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Overview

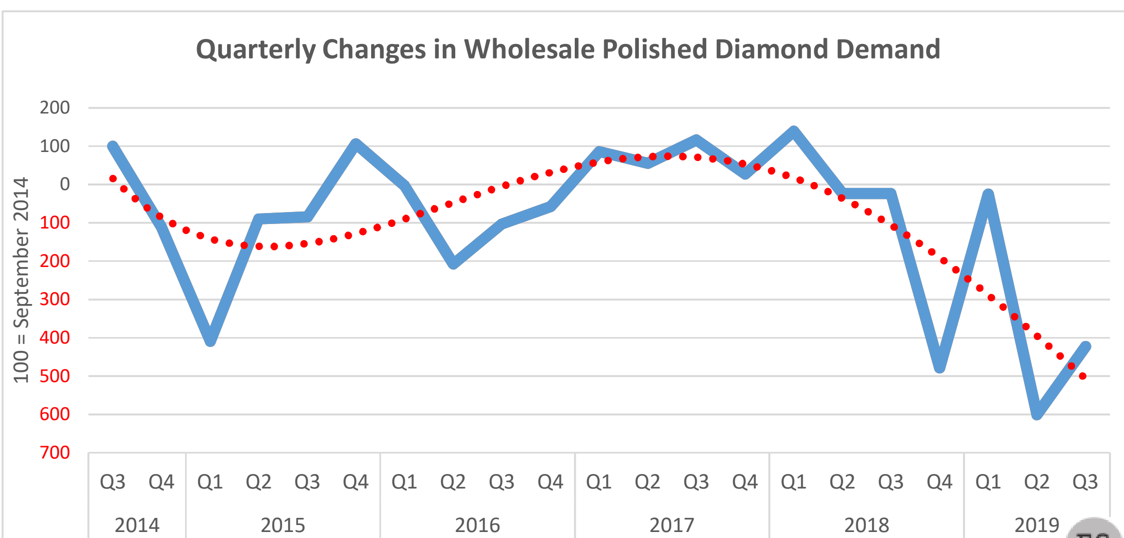
After an extended period of stunted activity in the consumer, wholesale, and manufacturing sectors of the global diamond value chain, at the end of the third quarter, there are a few small signs of improvement.

Following the deep decline in the second quarter of the year, US jewelry sales surprisingly picked up in July, although, cyclically, it is a month when sales normally decline. Improved retail activity in the US led to a certain rise in demand in the diamond trading centers in September. However, in China, the second largest market, the declines in sales continued and even worsened. Leading jewelry retailers reported deep drops in same store sales.

Polished Demand

In the second quarter, demand for polished diamonds fell in nearly every category of round diamonds. However, while the deep quarter-over-quarter declines continued into the third quarter, in a number of areas, demand flattened, and, in some cases, even improved. This is a small and important development, yet there is still a long way to go until the trading level of even last year is restored.

Considering the global economic and retail markets, it is not surprising that improvements are in goods for the American consumer market, and this reflects, among other expectations, in the trading centers – mainly in Israel.

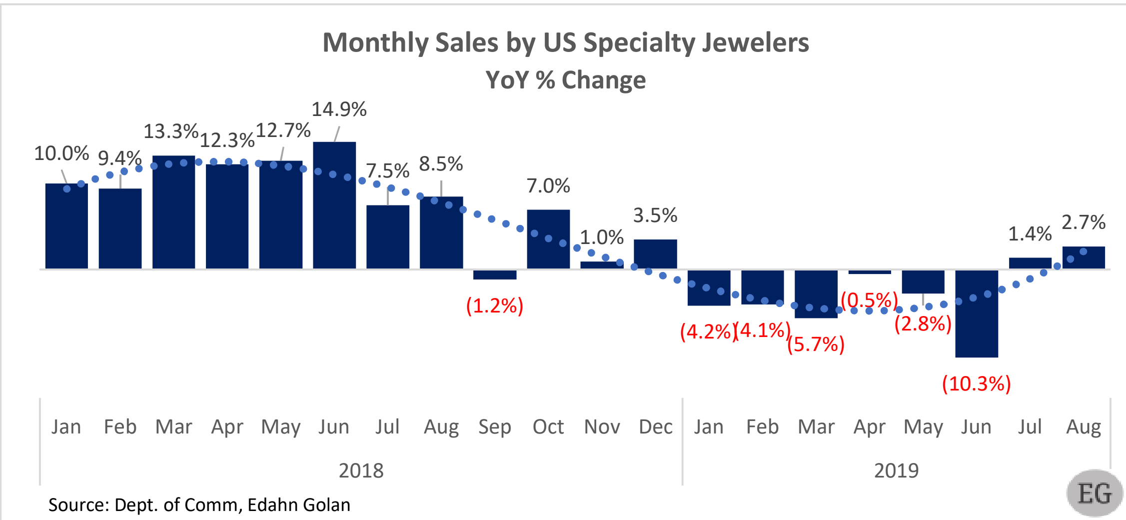


Source: Edahn Golan Diamond Research & Data Ltd

In 2018, for the first time in a decade, demand for polished diamonds in the wholesale section of the diamond pipeline fell in the fourth quarter – a glaring sign of the troubled times. Considering the recent increase in jewelry sales and the decrease in inventories, it is fair to expect a relative improvement in demand in the fourth quarter of 2019 that reflects more than just rising cyclical demand.

US

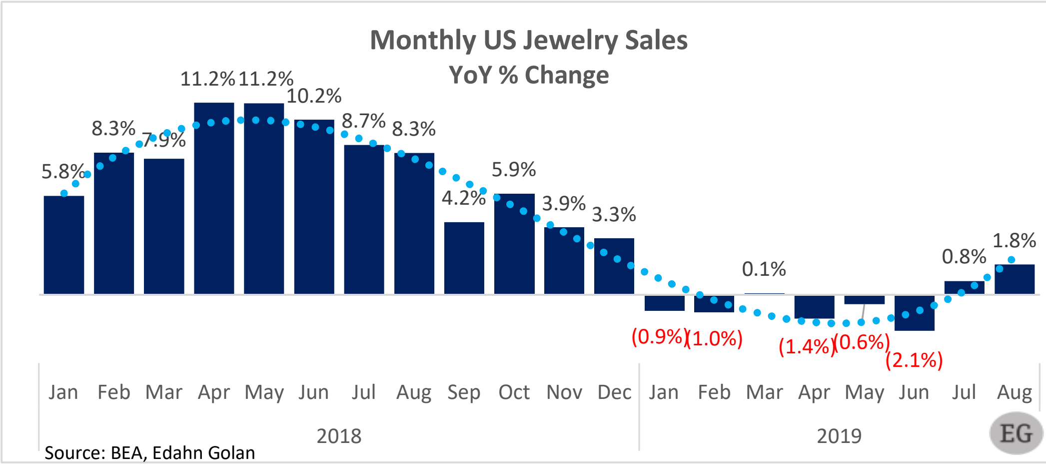
After a slow first half of the year for the US market, and a very tough summer for wholesalers, the market is slowly showing more signs of activity. According to the US Department of Commerce, specialty jewelers saw sales rise 1.6% to $2.41 billion in July. Although historically specialty jewelers see sales in July decline compared to June, this year sales uncharacteristically increased – up 4.5% month over month. In August, sales improved again, up 2.7% year over year. Although the July and August figures are modest, they are an improvement over the declines experienced in the first half of the year. September figures have not yet been released; however, based on early indications, the positive momentum is understood to have continued.



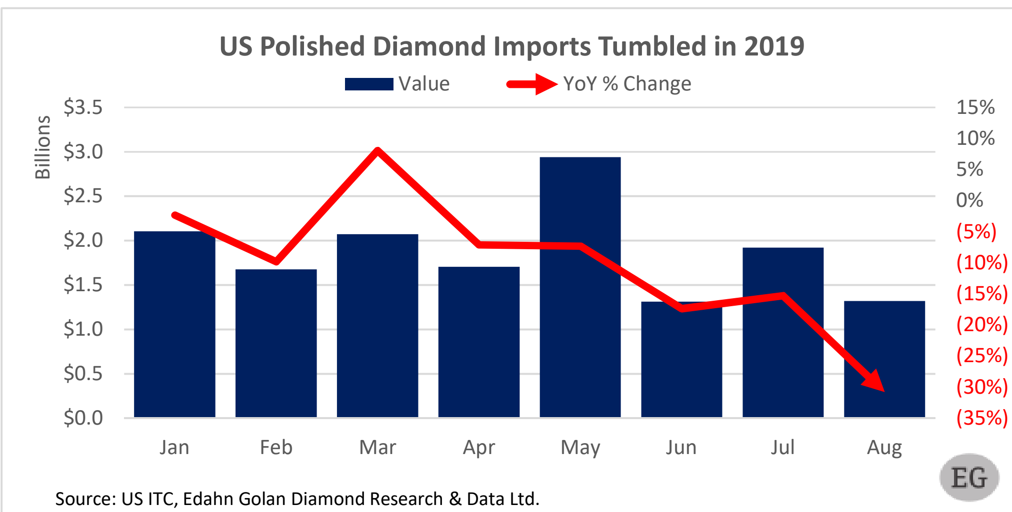
According to our latest estimates, total jewelry sales by all retail channels was $4.71 billion in August. This is a modest 1.8% year-over-year increase. Why modest? Because total consumer expenditures rose 3.8% in August. Despite these increases, polished diamond imports into the US fell 30.8% that month.

One component impacting consumer expenditures on luxury is the unclear state of the American economy. On one hand, there is a rising stock market and declining unemployment, while on the other, a volatile geopolitical situation may result in trade wars, rising costs of consumer goods, energy issues, and a president with an unclear long-term agenda.

Many jewelry retailers are reporting difficulties managing consumer expectations. These issues range from the ability to provide reliable sourcing data to explaining why the traditional engagement ring needs to have a large and pricy natural diamond. In addition, a wide range of jewelry retailers, of all sizes and types, are again pushing wholesalers to finance their inventory. While they are willing to buy and hold lower cost jewelry, there is a lot of pressure on wholesalers to provide pricier items on memo.



In the past, when money was abundant and widely available, providing loose diamonds on memo was a very common practice, especially by Indian traders competing for market share. Currently, with access to financing more difficult and costly, wholesalers are a lot less willing to provide goods in this manner. For wholesalers, cash flow is king.



Despite the rise in jewelry sales in July and August, demand for polished diamonds from the wholesale sector in the US dropped in September. Retailers were very exact in what they added to their inventories. Specifically, 3-4 carat oval-shape diamonds with triple excellent makes were in demand. One-carat rounds in GHI colors, VS-SI clarities – the bread and butter of the US market – are also moving. At the same time, the once popular princess-shaped diamonds have lost consumer interest.

India

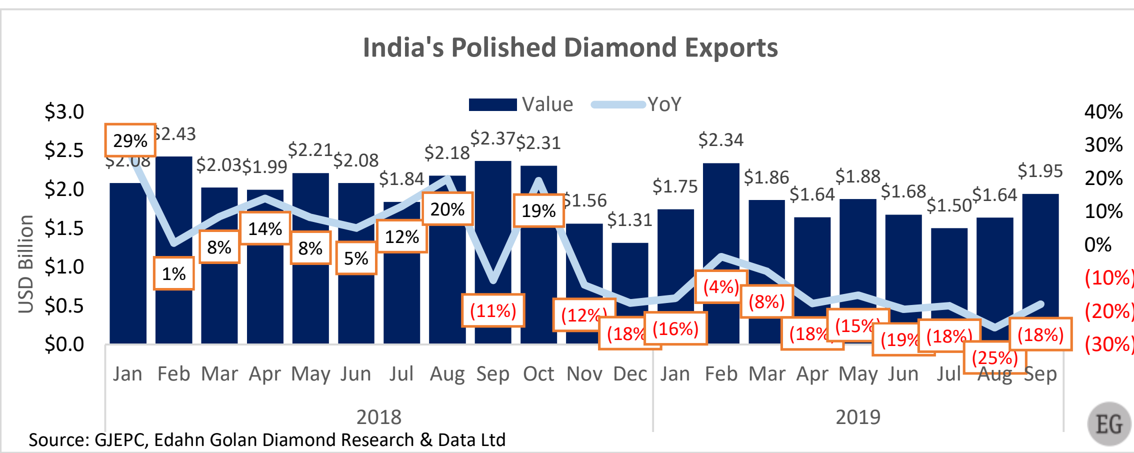
Indian diamond traders found some hope in the fact that the Hong Kong show in late September was not the absolute disaster they were expecting. Indian traders lowered prices wherever they could and needed to generate sales at the show. The goal was to generate cash flow and move older goods out of their inventory.

The Indian market is continuing to suffer from shrinking financing. Bank financing is fairly steady at an estimated $4 billion after a large decline in 2018. Secondary sources of financing, some of it from within the trade but not only, have also been curbed, resulting in two main effects: company downsizing and self-financing. Both serve the industry well, providing greater efficiency and stability.

Demand for polished in the wholesale diamond market in India dropped drastically for 30 and 40 points nearly across the board – pique and cape color were in neutral demand. Smaller goods are in great abundance with inventories spiking. One-carat rounds are also in over-supply, especially VVS items, resulting in softening prices. The strong demand seen until recently for oversize pears and ovals has dried up.

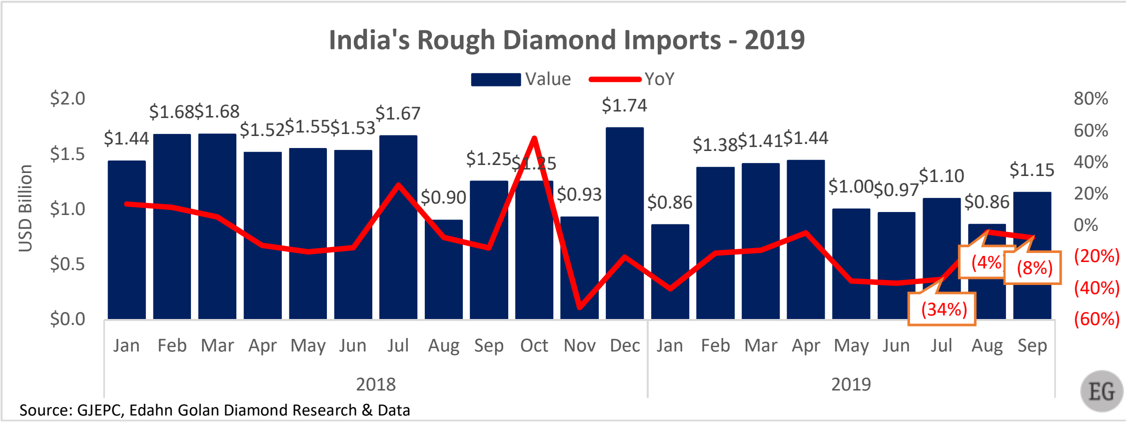
One area where wholesalers are seeing a shortage is in 1.5- and 2-carat GHIJ VS-SI1 goods.

Polished diamond exports from India remain low, down on average 15% year over year in every month in the past year, with the recent rise in exports in the third quarter reflecting a cyclical trend in August and September. By value, the Indian market suffered from an 18% decline in exports, a $3 billion loss of business.



Rough diamond imports usually rise or fall in unison with polished diamond exports. These imports fell low in 2019. In the first half of the year, the drop averaged 26.5% below the prior year. In the last two months, the declines moderated to mid-single figures. Again, a somewhat positive sign, but not very definitive.

Year to date, rough diamond imports are down 64.2% by value, a $1.86 billion drop in expenditure, mainly a loss of revenue for mining companies.

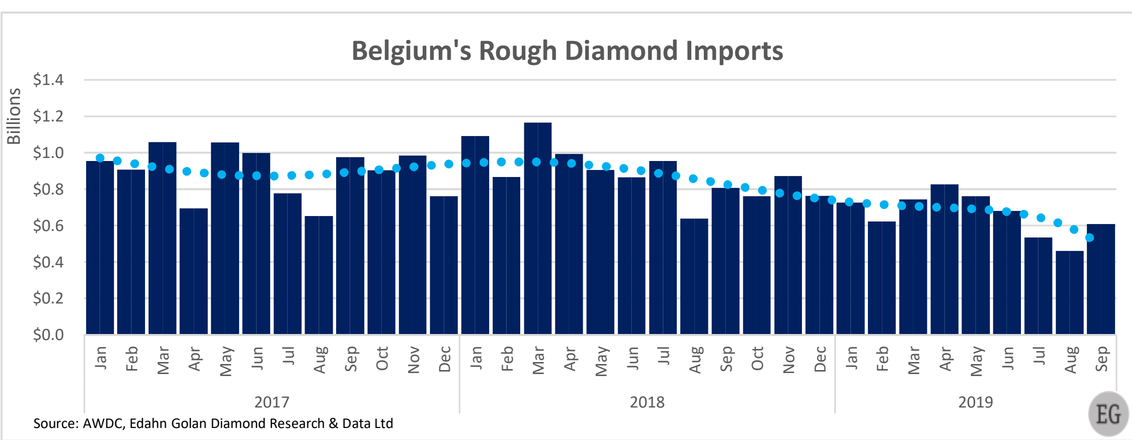


India's government reduced corporate tax from 30% to 25%, a move welcomed by the local diamond industry, though there is little expectation that this will have a deep impact on the industry.

Belgium

The value of Antwerp's polished and rough diamond trade sank in the third quarter. Polished trade fell 25.2% by value and 11.7% by volume, as the average value price per carat of traded goods declined.

Trade in rough diamonds plunged 33.9% in the third quarter although the volume of trade decreased just 2.3%. Again, this reflects the deep drop in average price per carat of the rough traded in through the Antwerp diamond center. The declines in year-over-year value of trade are the deepest since 2009, testament to the depth of the current problems affecting the entire diamond industry.



One of the main issues concerning traders is the drop in the value of their stocks. These stocks are their business assets. A quick reminder of the situation in 2009: the drop in stock value was one of the main issues hurting diamond wholesalers. Banks pulled financing as the value of assets that served as collateral declined. Some traders were unable to cough up the money needed to repay loans.

This industry-wide issue is what is pushing traders to rely more on self-financing. In addition, they are avoiding buying new stocks to replace sold items. The fear is that prices will continue to decrease. As one astute Antwerp-based trader said, “We stopped believing in our goods.

Hong Kong

The Hong Kong diamond market is finding it difficult to recover. After suffering from a crackdown on cash in Mainland China and then a drop in tourism, today it is impacted by the ongoing protests against the Extradition Bill, as well as the US-China trade tensions. All four events have hurt retail activity in the region, including diamond and jewelry sales.

The largest jewelry retailers were all impacted by the recent events. Chow Tai Fook and Chow Sang Sang reported double-digit declines in same store sales in the summer. At TSL, matters seem even worse. The company issued a profit warning, stating that it suffered from the weakest sales in the Hong Kong market in August and September, expecting a 45%-55% year-on-year drop. Profit for the six months ended September 30 is expected to plunge by more than 90% compared to the corresponding period last year.

Justly or not, the Extradition Bill demonstrations are viewed as violent, and some expressed concerns that criminal elements may be taking advantage of the situation, using the protests as a cover for criminal activity. Due to these concerns, many jewelry and diamond traders were hesitant to visit the local jewelry show that ended on September 20. Some exhibitors also canceled their attendance, either officially or in practice by simply not shipping goods to the show. Several insurance companies reminded their clients that their policies do not cover civil disobedience.

For such low expectations, the trade fair’s outcome was eventually considered as “not bad” despite the reduced traffic. Chinese buyers and retailers were noticeably absent, and much of the business activity for diamond wholesalers was inner-trade. Traders sold wherever they could make a profit, as small as that may have been. Indian traders were noted for lowering prices. At times, traders sold goods at low prices when they knew they could buy replacement items at even lower ones. This helps them reduce the value of the pricier items in stock and to improve profits.

Sales of goods below 1-carat pointers were very slow. Larger goods up to 3 carats, moved well. Indian buyers were after large 5-carat goods in LMN colors and VS-SI clarities.

Local Hong Kong retailers were after 1-carat rounds in EFG colors and VS-SI clarities. Demand was also noted for emerald-shaped goods for necklace layouts, ranging from 20 points to 1 carat. We also received a report of demand for 10-carat Marquise, FG/VS stones, which are difficult to come by.

Israel

The Israeli market is continuing to shrink. A decline in scope of manufacturing, a sharp drop in international trade, and a decrease in bank financing far below $1 billion is leading to more business closures of weaker companies without wide consolidation.

Israeli traders were prepared for the decline. They had set aside a war chest, as seen during the 2008-2009 financial crisis. While the shrinking bank financing is hindering most traders' growth, their self-financing is keeping them afloat. Despite all the challenges the Israeli market is facing, an improvement in demand for polished diamonds in September is giving them some hope that there is light at the end of tunnel.

One of the center's biggest challenges is how to reinvent itself. A center with knowledge, but shrinking manufacturing and declining financing will find it difficult to add value in any industry. The country, nicknamed the "Start-up Nation," is the leading provider of technological tools to the diamond industry. Various efforts have been put forth to leverage technological know-how to support the industry, including the establishment of a tech hub in the diamond exchange. To date, while promising, these efforts have yet to mature, and the benefits to the center's competitiveness are not being felt at present.

One of the growing sources of income for many Israeli traders, besides real estate, is lab-grown. An increasing number of companies are growing and polishing LGDs, and establishing sales offices in the US catering to this retail market. Gaining first-hand access to rough diamonds sourced from junior and alluvial players in Africa and trading those goods is another source of income.

In terms of demand, the Israeli market remains focused on serving the US retail market, while the Far East and Europe remain weak. Demand is very selective, with reported shortages in some goods. Overall, the market seems stable with fewer categories in declining demand and a small increase in the number of categories in rising demand.

Demand for the smallest goods was mixed. Half-points were steady with price declines, one-points were in some demand, sizes 3-5 points were weak, 5-8 points were strong, and 0.08-0.17 carats were very limited, with traders avoiding holding them in stock, preferring to pay high premiums of 10% and higher when needed to satisfy standing orders. Five per carat was in stable demand. Demand for VVS clarity goods in these size ranges was practically "dead," according to Israeli traders.

Because these sizes are used for mass settings, demand can be very specific. For example, 1.5-mm stones are moving much better than 1.6-mm ones.

Quarter-carats moved well, especially those with higher color and better clarities; however, the price spread between categories is unusually wide. Thirds weakened in demand after an improvement in prior months that led to shortages. There seems to be a correlation between quarters and thirds. When one is in better demand, it is often at the expense of the other. One-, three-, and four-carat rounds were in declining demand. Two-carat rounds were in good demand in specific areas.

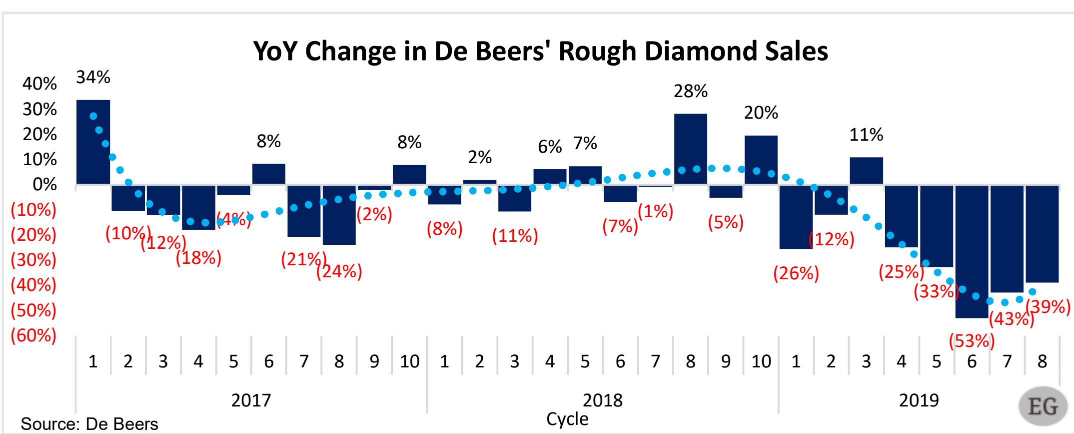
There was high demand for ovals and pears and good demand for emerald- and radiant-shaped in 1.25-2.50-carat sizes. There was low demand for princess and marquise cuts.

In fancy color, 3 carats and up moved well. Demand is focused on very high makes. Anything else is unacceptable. Most orders are against specific orders. Vivid yellow goods were in limited demand, while fancy, fancy light, and Y-Z colors sold better.

Miners

The decision of the leading miners to slow down rough diamond supply has started to have a positive impact. De Beers and ALROSA, while keeping prices steady, reduced supply and allowed their contracted clients to adjust what they're buying. With traders able to spend less by buying specific needed goods, the burden of buying and holding stocks of diamonds that they can't sell has eased some of their financial pains. That burden is now on the balance sheets of the two leading miners.

Looking at the changes in sales by the two leading diamond miners shows that over the past year, their sales have mainly gone down. The year-over-year declines were especially deep during the third quarter, down on average 37% (ALROSA) to 41% (De Beers). This is a $750 million loss in revenue between the two of them.



At the same time, both companies had an increase in rough diamond sales during their last two sales cycles. The increases were not very large, and far from being a

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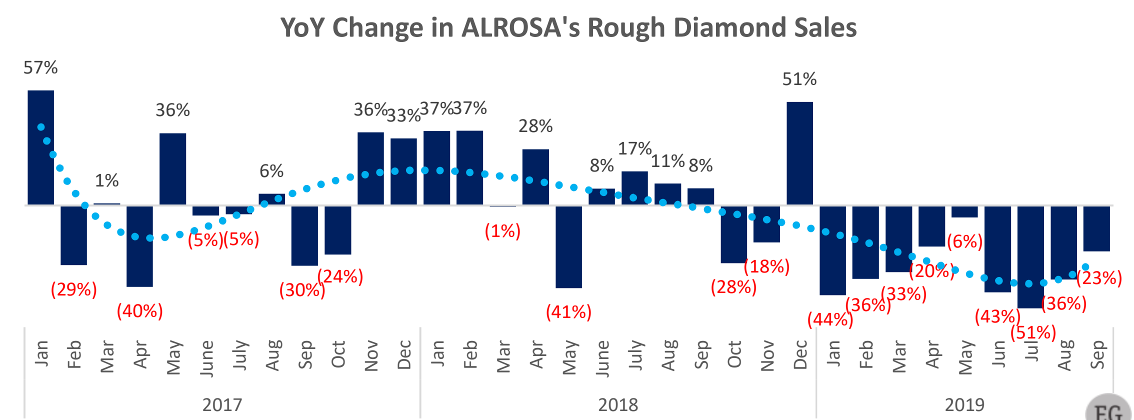
trend, yet they do serve as additional indicators that the industry just might be seeing a small turn for the better.



Source: ALROSA

Meanwhile, other diamond miners with direct supply to buyers have lowered supply and prices, adjusting to current market conditions. Rio Tinto's third quarter production declined 7% year over year and 9% year to date. This is in line with market reports that its supply fell 7-8%. Prices were reduced 10%.

The company is maintaining its full year production guidance at 15-17 million carats. It has not fully given up on diamonds, moving forward with its advanced project in Falcon, Canada, brownfield in Diavik, and greenfield projects in Canada.

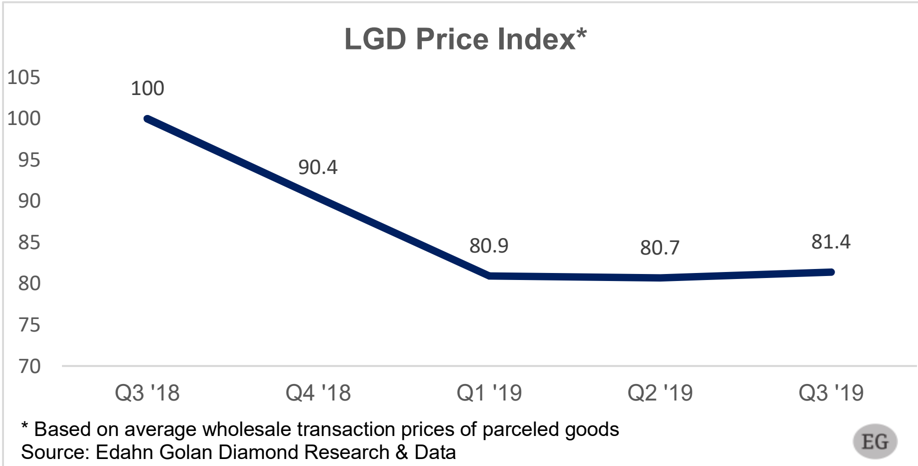
Other direct sellers are also reducing supply and prices at a similar rate to Rio Tinto. Attendance at rough diamond auctions is rising, with buyers seeking very specific goods.

LGD

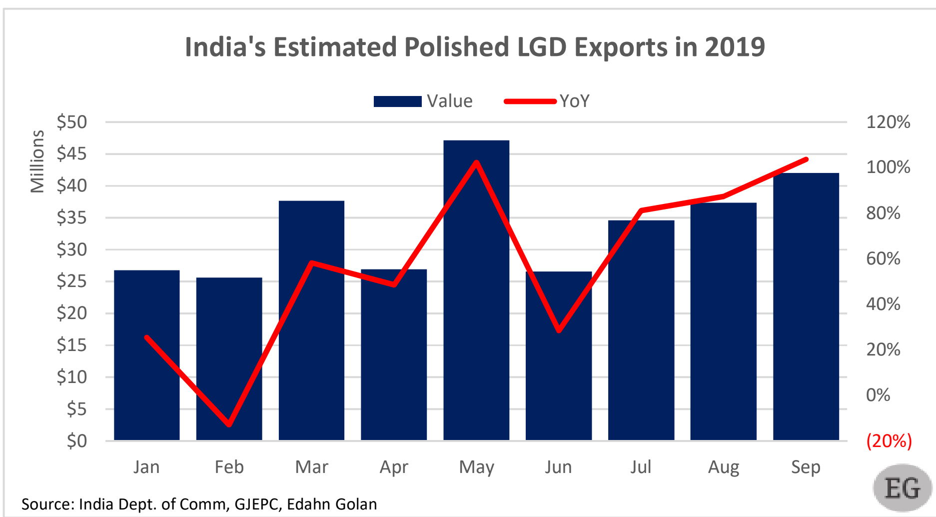
A year after De Beers' LGD jewelry line Lightbox was launched, it seems that the diamond industry's battle for repositioning lab-grown in the market has largely succeeded. Prices of LGD and LGD-set jewelry fell and consumer demand is so far limited. Yet LGD has gained some important footholds.

Wholesale transaction prices of polished lab-grown sold in parcels have declined18.6% year over year. Down the jewelry pipeline, retail prices declined even more as specialty jewelry retailers have learned more about the new product over time, and their initial enthusiasm has been replaced by a more sober demand for lower costs from wholesalers.

A rise in the number of growers, competition among wholesalers, and a rising share of the lower cost HPHT have all contributed to the decline in wholesale prices, as well as Lightbox's unified $800 per carat price point, which convinced retailers to demand lower costs.



The number of Mumbai diamond traders that are seeking refuge in LGD is rising exponentially, and this competition comes with a price. On one end, Chinese growers are raising prices of rough LGD. On the other end, retailers are demanding to get goods on memo. Currently, traders are complying and paying more for the rough and supplying a very large percent of their goods on memo.



The need to buy at higher prices and finance retailers' inventory, while facing off growing competition also has its price. As in wholesale sections of most industries, including diamond/jewelry, wholesalers are getting squeezed between raw material suppliers and retailers.

In the third quarter, costs of lab-grown increased in key areas: 0.50-0.99-carat goods due to trader demand outpacing grower supply. At the same time, 1-carat round LGD declined 7.2% compared to the second quarter and 26.1% compared to the third quarter of 2018.

Consumer demand remains fairly limited. Sales are currently capped at about 2% of retail diamond jewelry sales. This is surprising considering the extensive press coverage LGD is enjoying. Somehow, this has not sent consumers in droves to demand LGD.

All of the above come with caveats. In the third quarter, wholesale transaction prices increased, mainly due to higher rough prices demanded by Chinese growers. The number of American retailers offering lab-grown set jewelry is rising steadily, and counted among them are not just price-point stores, but large chains and guild retailers too.

Until recently, lab-grown set jewelry was of interest almost exclusively in the US. This is changing. The LGD market is expanding to Europe and Australia where more retailers are starting to offer it.

The most significant change is among consumers. While demand is still fairly limited, it is characterized by a shift towards bridal jewelry, the backbone of the diamond business.

The majority of LGD-set jewelry sales by value and unit are of bridal jewelry. This is contrary to hopes in the diamond industry that LGD would remain limited to fashion jewelry. This is something the diamond industry should pay attention to, perhaps through its collective Diamond Producers Association (DPA) efforts.

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