MARKET CORRECTION

Diamond markets under pressure. Rough prices must go down, polished prices must go up and manufacturers must make money.

BY MARTIN RAPAPORT
Markets don’t lie but they do correct. Over the long term, free markets are perfect because they equate supply and demand by establishing democratic prices that honestly reflect the relative value of all goods and services in the market. In the short term markets are often imperfect, as they reflect manipulation and abuse by interested parties seeking to gain short-term profits at the expense of long-term sustainability.

Trading short-term profits for long-term losses is a dangerous game. Going for the easy fast buck in a carpe diem “live for the day” world creates market imbalances. The inevitable correction of these imbalances often takes place at the worst of times, when market forces are negative. Such was the case in the 2008 housing crisis when banks over-extended their credit, resulting in unsustainable housing price increases.

Obviously, taking short-term gains at the expense of long-term loss is not wise. Whether it’s going to a party instead of studying for a test, eating too much at a fancy dinner and eventually suffering a heart attack or borrowing too much money and then being forced into bankruptcy, the long-term price you pay is not worth the short-term benefit.

Many firms cannot resist the temptation of immediate economic gratification. Whether it’s taking too much money from the banks, bidding up rough prices to unsustainable levels, increasing revenue at the expense of profits, bribing government officials, selling overgraded diamonds, mixing synthetics into parcels of natural diamonds or simply not paying bills, it’s hard to resist an easy fast buck. The situation has become worse as structural defects in the dynamics of the diamond markets have destroyed the ability of firms to make normal profits. Competition from firms engaging in unsustainable practices has also forced some good firms to make bad decisions just to stay in business.

For example, if your competitor takes on huge debt so that he can overpay for rough diamonds, what should you do? Must you close your factory or should you also pay too high rough prices in order to stay in business?

Unfortunately, global diamond markets have been predisposed to making bad short-term/long-term trade-offs. In a nondifferentiated competitive market, legitimate firms have been forced to compete with firms that take shortcuts enabling them to offer lower prices. The net result is that cycles of negative behavior have developed, exposing the trade to significant economic and reputational risk.

We have now reached the stage where leading diamond manufacturers and dealers have come to the realization that their current business models are unsustainable. In the words of Maxim Shkadov, president of the International Diamond Manufacturers Association (IDMA): “Our sector is going through a severe crisis and suffers significant problems. … There is no profitable income to be made in diamond manufacturing. … The seriousness of the ‘disconnect’ between the producers (miners) and the manufacturers can no longer be ignored.” (See “President’s Letter,” page 58.)

Shkadov is talking about the unsustainable disparity between high rough and low polished diamond prices. He is protesting the disregard of mining companies to the plight of diamond manufacturers who can no longer make profits.

From the miner’s perspective, there is no reason not to accept the high prices that diamond manufacturers offer for the rough. What the manufacturers do with the rough and whether or not they make profit is of no concern to the miners.

Underlying all this is the role of the Indian government and bankers who have enabled the over-financing of the diamond business, resulting in irrationally high rough prices that ensure manufacturing losses.
The situation in the diamond trade has reached a desperate point where firms have lost confidence in how the market operates. Simply put, good people are working their hearts out and losing money. As losses increase, some are panicking, they do not want to lose their life savings. Many blame De Beers and the other mining companies, others blame Rapaport and RapNet because our price list and trading networks promote transparent competition that makes it hard to raise polished prices. The trade is caught between rough and polished prices. The diamond community is afraid for their future and the leadership does not know what to do.

UNDERSTANDING THE SITUATION

While the situation is highly complex, it is understandable and solvable. In fact, the crisis we are currently experiencing is healthy, as it provides an opportunity for the diamond trade to right itself and realign short- and long-term market priorities. If we handle the crisis correctly and make the necessary corrections, then we can transition our trade to higher levels of sustainable profitability with unlimited growth potential for the future.

It is important to recognize that the crisis is uniting us in the quest for honest, durable solutions. Solutions will not be developed by firms blaming each other but rather by working together in a cooperative manner to create fair diamond markets that serve the mutual benefit of our community.

Our first step is to gain an understanding of what is really going on. The diamond trade currently faces two very different types of challenges and it is important that we do not confuse them.

External challenges created by events beyond our control. This includes macroeconomic events that have reduced demand, such as slower growth from China, a weaker euro and ruble and lower oil prices. It also includes a broad range of additional external forces, such as rapidly advancing technology that changes everything — including our ability to synthesize or treat diamonds, how consumers buy diamonds over the
internet, changes in fashion, lifestyle and demographics and new competitive luxury products.

**Internal structural challenges.** This includes factors that are fundamental to the way the diamond trade operates. For example, bank debt, inventory levels, production volume, costs, labor, liquidity, diamond prices, marketing, profits and a host of other factors determine how we perform and interact within the diamond trade.

While the external challenges we face may appear frightening at times, they are not a real threat to our existence. As any other industry does, we have the ability and responsibility to change and adapt to the world around us. Changing global economics, demand scenarios and distribution systems are nothing new. One year China is weak, the next it is strong, so what? External changes are no big deal. We can handle them.

The real problem is that the way the internal structure of our industry operates is unsustainable. We have created a self-perpetuating, highly complex interactive environment that forces market participants to act irrationally and in ways that destroy their ability to make profit.

A good way to understand the situation is to follow the money. Here is a simplified storyline.

**Banks lend** too much money to diamond manufacturers and rough dealers. In some instances, banks lend 100 percent of the cost of rough. So buying rough and reselling it is a way to create cash.

**Excess money supply** causes rough prices to be higher than the resultant polished. Rough costs more than the polished is worth. Manufacturers consistently lose money.

**Manufacturers bleed** money out of the system, using transfer pricing scenarios to store some $13 billion of “extra money” in offshore tax-free companies.

**Manufacturers continue** to lose money to the extent that they can no longer pay back banks.

**Manufacturers become addicted** to credit. They must keep manufacturing, even at a loss, to keep credit lines in place. At some stage, manufacturers must increase borrowing just to make interest payments.

**The more manufacturers** keep manufacturing, the more overpriced polished they produce.

**Oversupply of polished** and weak global demand push polished prices lower.

**Banks realize** they are not going to get their money back and try to exit, but they can’t. So they keep their credit facilities open, hoping that polished prices will increase and manufacturers will pay back loans.

**Banks confronted** with Basel III regulations are forced to reduce their credit limit. The diamond industry is seen as high risk, requiring extra compliance and higher interest rates and banking fees (see “Improved Profitability, Transparency Equals Bankability,” page 60).

**Manufacturers begin to panic** and lose confidence. They don’t know how to keep the game going and don’t have the money to pay back the banks.

**Trading stalls** and cash flows decrease as large manufacturers refuse to sell at lower polished prices. Manufacturers are afraid that if polished prices fall any more, banks will shut them down and the diamond trade will collapse.

**SOLUTIONS**

**Solution 1:** Banks must reduce credit to diamond manufacturers.

It’s obvious that the primary cause of the crisis is excess liquidity in the manufacturing sector. Too much money is chasing rough, which is why rough prices are higher than polished. It’s time for the banks to shut down their money supply until rough prices come down to the extent that manufacturing is profitable.

Banks must not support artificially high unsustainable rough prices by providing loans for uneconomic activity. Such high prices have destroyed the level playing field by making it impossible for firms to profitably manufacture. What is a legitimate diamond manufacturer to do if rough prices are higher than polished prices? He is being forced to stop manufacturing because of high rough prices. Good people are being forced out of business by irresponsible banks.

It’s time for the banks to have an honest, “transparent” conversation with their clients and credit committees. No more making believe that everything is okay and still funding yet more unprofitable diamond manufacturing,
Such funding makes matters worse and adds fuel to the fire by increasing polished supply that further depresses polished prices. If banks want to wait out these times of diminished demand and speculate that polished prices will significantly improve, that’s fine. But please, no more financing of unprofitable manufacturing.

A word to the wise in India’s government and banking sector: We realize India’s diamond cutting sector supports the livelihood of millions of people and that significantly reducing manufacturing activity may result in short-term unemployment and hardship. The most likely outcome of denying credit to unprofitable activity is a short-term decline in diamond manufacturing, followed by a significant reduction in rough prices sufficient enough to ensure a profitable and sustainable Indian diamond cutting industry. Continuing on the current course of action whereby unprofitable activity is financed destroys the ability of rational and small, nonfinanced firms to manufacture diamonds and harms the market for millions of Indians who rely on diamonds for their daily bread. I urge you to implement rational credit restrictions.

If banks deny credit to unprofitable activities, sales of overpriced rough will plummet as funding dries up. One or both of two things will happen: One, rough prices will...
decline, enabling profitable diamond manufacturing and/or two, mining companies will keep rough prices high and sell less rough. This will reduce manufacturing activity and create shortages of polished. Polished prices will increase due to shortages. Either way, the markets will be moving toward a correction and manufacturers will not be creating losses and dumping more diamonds into the market. The trade may not make money in the transition but they will be minimizing their losses while setting the stage for improved market conditions.

**Solution 2: The trade must support polished prices.**

The diamond trade must prioritize the purchase of polished diamonds over rough diamonds. It makes no sense to buy rough that is more expensive than existing polished. Buying polished instead of rough has a double benefit. It supports polished prices while reducing the amount of new polished entering the market. It dries out the market, creating shortages that enable future polished price increases.

The current crisis of confidence in the manufacturer and dealer markets is the result of uncertainty about polished diamond liquidity. Dealers do not know at what price they can sell their polished diamonds. They do not see a price floor and are therefore afraid to buy for inventory. When dealers stop buying, trading volumes decrease, liquidity dries up and markets begin to freeze up. That is the danger we face now.

The solution is for the trade and Rapaport to work together to promote liquidity and confidence by establishing and communicating firm bid price levels with reliable floor prices for polished diamonds. If buyers know that they can sell, then they will have the confidence to buy.

**TRANSPARENT COMPETITION**

About seven weeks ago, just before the Hong Kong show, a number of large Indian diamond manufacturers decided to price the diamonds they offer for sale on RapNet (the Rapaport Diamond Trading Network) at full Rapaport List prices. The Indians, concerned about deteriorating market conditions and losses, believed it was important that they stop competing with each other on RapNet. They felt that price competition was bad for their business.

Some market players saw this as a protest against Rapaport, but in my view, I saw nothing wrong with companies pricing diamonds any way they wish. The whole idea of RapNet is that the trade quotes specific independent asking prices that are not based on Rapaport opinion. Our policy is not to interfere with any pricing on RapNet, other than to require that all diamonds under 4 carats have some price.

The pricing change by the large firms was interesting, as it moved their listings down on RapNet and opened up new opportunities for smaller companies whose diamonds now received more prominent and competitive positioning. When surveyed, some of these companies reported a 30 percent increase in sales. This is in spite of relatively poor market conditions. The lesson here is that smaller firms play an important and vital role in downward-moving markets. They are the core of our business during difficult times. I strongly encourage all firms to price diamonds any way they want and I am

“The primary cause of the crisis is excessive liquidity in the manufacturing sector.”
pleased that smaller companies are able to use RapNet to grow their business while larger companies still serve and attract customers the way they want.

On April 6, a number of Israeli companies also began listing their diamonds on RapNet at full Rapaport List prices. The Israelis announced that they were doing this in protest against downward movements in the Rapaport Price List. Since then, there have been formal requests that we stop regularly publishing the Rapaport Price List and boycotts of our services by some Israeli firms.

While my heart goes out to all the firms suffering from adverse market conditions, the Rapaport Group will remain true to its mission and has issued the following statement:

“A fundamental value, purpose and function of the Rapaport Group is to create, promote and support fair, transparent, competitive and efficient markets. We recognize that many diamond suppliers are under severe financial pressure and oppose transparent competition, which they believe reduces their profit margins. While we sympathize with the difficult market situation suppliers are experiencing, Rapaport remains firmly committed to maintaining transparent competitive markets and honest pricing at all times, including during periods of declining prices. We believe that buyers and sellers must have access to fair price information in declining markets and refuse to restrict the flow of our information to suit the needs of suppliers who wish to protect their profit margins at the expense of buyers. We believe in fair markets and reject the notion that the interests of suppliers are more important than those of buyers.”

Having said this, we should recognize that many diamond suppliers are against transparent price competition. Would our industry be better off with less competitive price information? Are efficient, informed markets the enemy of profit margins? As stated above, I think the opposite is true. We need more customers and the confidence that better information will help create. Our intention is to move forward not backward. Specifically, we call on the diamond trade to work with us to establish a firm bid/ask market that will build confidence and significantly expand the diamond trade.

THE BOTTOM LINE

The current market situation is not as negative as many of the suppliers think. Polished diamond prices have come down as expressed on RapNet and

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<td>37,840</td>
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our Rapaport Price List, but they are stabilizing. The fact that approximately 30 percent of rough was rejected at the last De Beers sight is comforting because it shows that the industry is behaving responsibly by reducing supply as demand declines. Furthermore, declining rough purchases reduce financial pressure on suppliers, making it less likely that they will have to sell off existing polished inventory at below market prices.

While there is an oversupply of diamonds throughout the distribution system, U.S. demand is consistent and other markets are continuing to make purchases. We anticipate a slow draw down of inventories and relatively stable market conditions provided that there are no significant supplies of new diamonds introduced into the market.

Diamond suppliers are encouraged to calm down, be patient and let the market correct itself. Some have seriously overextended themselves and may have to take losses and wait out the situation if possible. Do take care of your employees as best you can.

While we encourage bankers to restrict credit to profitable enterprises, now is not the time to call back loans and force companies to dump inventory. Keep a steady hand. Be careful about extending new credit, as you do not want to finance new supplies into the market until demand conditions improve.

No one can blame De Beers or other miners for taking the money offered to them. In any case, this is a good time for miners to lay low and not put any pressure on the market to buy new rough. Keeping prices high and selling less goods seems to be working for now, but it is not sustainable over the long term. When demand returns, miners should consider increasing supplies to the market by dropping prices about 20 percent. Manufacturers need healthy profit margins to sell diamonds. If miners strangle their customers and bypass the middle markets, they won’t be able to sell their diamonds in the future. Miners must adopt a live and let live strategy. Recognize that the game with the banks is now over.

To the buyers, relax and ignore all the noise coming from the suppliers. Concentrate on buying what you need when you need it. Expect shortages as the quantity of new diamonds being produced declines. Talk to your merchandisers about being more flexible and designing jewelry that uses a broader range of sizes and qualities.

“We reject the notion that the interests of suppliers are more important than those of buyers.”
Time flies. As January 2015 is coming to a close, it is now clear that we still carry the burden of 2014 with us. As forecast last year, the reduction of diamond prices — as reflected in the Rapaport Price List — offers proof of the supply of polished far exceeding demand. In practical terms, this means that we all have to get used to the new normal in polished diamond trading: a lack of control of the volume of the goods that is released to the market.

It saddens me to see — and say — that the rift between the interests of the diamond mining companies and the companies that are represented by IDMA is becoming wider year after year. I think the seriousness of the “disconnect” between the producers and the manufacturers is such that it can no longer be ignored. However, in a recent media interview, De Beers CEO Philippe Mellier proved that from De Beers point of view, all is fine. Demand is up, and prices are on the rise. Good for them. But by taking this one-dimensional position, it negates the need for the health of all players in the diamond supply pipeline to be strong. And, as IDMA president, it is my mission to defend the interest of those players in the diamond supply pipeline who are most vulnerable to the policies of the producers.

Of course, companies like De Beers and ALROSA are required to satisfy their shareholders and to project their annual budget forecasts, which need to reflect an increase in demand for rough diamonds — and they base their projections on the demand they expect to get from existing or potential clients.

It is this — flawed — model that causes the “disconnect” between the — big — producers and the downstream pipeline. Basically, the producers consciously turn a blind eye to developments in the downstream section of the pipeline. Their sales and pricing models do not incorporate or take into account the demand and prices paid for polished, nor do they assess the cost of manufacturing, let alone the financing needed to turn rough into polished goods. As Mr. Mellier said: “...that’s not down to me.”

As I said earlier, the system of sales, where clients are cajoled into buying at prices that they know are not going to make them money, purely out of fear of being deleted from the supplier’s client list, is flawed. Industry analyst Chaim Even-Zohar called this the Prisoner’s Dilemma. In practice, it means that the mining companies overcharge current clients, squeezing the very last drop out of them.

There seems to be a fundamental flaw in how the players in the rough market perceive the diamond business. Firms like De Beers, ALROSA and others apparently want to realize their dream to sell all run-of-mine output directly to the big jewelry corporations such as Tiffany & Co, Chow Tai Fook, Sterling and so on. They are mistaken. Why so? Because the supposition that they will generate more profit by increasing these jewelers’ margins is not realistic. This is a business that cannot work without dealers, without companies that tailor a polished production to their specific needs, without suppliers that operate in niche diamond product markets. And are these jewelers ready to take on the role of dealers? Will they start holding stocks, financing them, channeling them into the downstream market, arranging for and issuing payment terms and be faced with the reality of holding significant stocks that they are unable to sell? And once they grasp what is needed to be a big client of the producers, will they gladly take on the many downsides that come with that privilege? The producers who continue this line of business are damaging the entire downstream pipeline. My advice to the producers’ clients is: Be responsible, and do not buy!

The figures that industry analysts have presented at recent industry gatherings are also pure fiction. In June 2014, during the 36th World Diamond Congress in Antwerp, Martin Rapaport said that the cost difference between
rough diamonds and the wholesale cost of diamonds is 30 percent. In December, at the inaugural World Diamond Conference in India, Chaim Even-Zohar raised that figure to 35 percent. (Why he did so is beyond me since in his annually published pipeline, it usually stands at 16 percent to 18 percent.) My colleagues and I — the manufacturers in this world — are telling you: It is zero percent!

In his interview with JCK, Mr. Mellier said that it is possible to earn money on De Beers diamonds, but does not specify how and where that is possible. I take that as a complete lack of understanding of what it takes to manufacture diamonds.

So, dear colleagues, let’s tell the truth, to each other and to those who are willing to listen. There is no profitable income to be made in diamond manufacturing. There is certainly not a 30 percent to 35 percent margin, nor is there added value generated at a rate of 16 percent to 18 percent. There is only a gain of 5 percent to 6 percent but that is not added value or profit — and this percentage does not cover financing, expenses and modest staff salaries.

If the margins are as indicated by the analysts, why on earth would sightholders and other core clients be ready to sell off their boxes — wrapped and sealed — for a margin of just 1.5 percent to 2 percent? As if they are car dealers who sell a car out of the showroom?

“If you look at a business I know very well — car dealers — they make 1.5 percent, and they are all smiling and happy about it,” Mr. Mellier said. Well, maybe it is time Mr. Mellier — and others — take a moment to learn this business and the diamond manufacturing world. Unlike the car industry, the diamond industry is completely different because very different polished diamonds are produced from diamonds that start out as very similar pieces of rough — sold at similar prices. One rough stone will result in a Renault Laguna, a top luxury sedan model, but the other just a Renault Clio, a lower-end, much cheaper compact.

While we are blessed with highly advanced planning, decision making and manufacturing technologies, the outcome of production is never guaranteed. And as we members of IDMA all know, this means that we not only cannot predict the added value of our production, we also cannot guarantee or plan its quality and character.

So, for the sake of the audience, let’s continue the comparison to the car industry and describe what the result is in the downstream market of the “unpredictability” of diamond manufacturing.

Let’s say that the market demand for the Laguna model is high, and prices are firm. Unfortunately, the rough supplied that was supposed to yield luxury Lagunas resulted in compact Clios, and maybe a few mid-size Meganes, Renault’s mid-sized family car, for which demand is low. That leaves the manufacturer with a stock, and in order to sell it he will need to carry out a promotion, and thus sell at a lower price than that projected.

But it gets worse. Currently, the dealerships — the downstream market of wholesalers, jewelry manufacturers and retail jewelers — tell us that they cannot sell the cars — even the compacts — at the prices we demand, due to surplus stocks, price resistance and a lack of interest in the retail and consumer market and competition from competing industries. In other words, the price of polished is down while the producers keep raising the price of rough.

Of course, there will always be commentators and advisers who suggest that the only way to get around all this is by shortening the supply pipeline, and to get jewelry manufacturers and retailers to take ownership of part of the upper end of the supply pipeline. While that may work for some of the larger jewelry entities, it still does not solve the problem of the overwhelming majority of diamond manufacturers, our IDMA members.

Under these circumstances — and I now refer to Mr. Mellier’s words about marketing and advertising — how can we be expected to finance any generic advertising if we cannot generate the margins needed that will allow for the investment of hundreds of millions? IDMA is an early adopter of the World Diamond Mark, and we strongly believe in the need for generic marketing and promotion of diamonds. We do, however, need oxygen to breathe life into this. How many diamonds are used in the Forevermark program? I believe not more than 2 percent to 4 percent of De Beers sales. In other words, generic marketing and promotion is a must.

In conclusion, on behalf of IDMA, I want to address all key players, especially the rough diamond producers. Our sector is going through a severe crisis and suffers significant problems. We can solve them together but we simply cannot bear the responsibility and the burden single-handedly. Rough diamond prices must be in sync with polished diamond prices because polished diamond prices are determined on the basis of supply and demand, while rough diamond prices are speculative, due to the flawed, coercive supply system, as described above.

**Good luck and common sense to all!**

Maxim Shkadov, president,
International Diamond Manufacturers Association
As the diamond industry is considered “increased risk” by the banks and their regulators, lenders have reduced their financing of rough diamond purchases and expect diamantaires to improve their profitability and transparency levels. In a recent conversation with Martin Rapaport, Erik A. Jens, head of ABN Amro’s Diamond & Jewellery Clients, discusses the key issues governing diamond industry financing.

**Martin Rapaport:** How do you perceive the market at the moment?

**Erik Jens:** The mining companies are becoming more adaptive in their supply strategies and more demand driven maybe. That has to do with their capacity but also the fact that sightholders have realized that they cannot buy rough just for the sake of it and lose money in the process.

That’s a big change from the past few years and it’s in line with the banks’ calls for companies to focus on becoming more bankable and transparent.

In the old days, there was basically one rough diamond supplier. Prices were high, but everyone made money as there was a consistent flow of diamonds at a consistent price. That’s not the case anymore. It’s like the book by Spencer Johnson, *Who Moved My Cheese.*

The middle segment of the market has been able to restructure itself to some extent in order to buy rough from different sources. A manufacturer is going to get into trouble if it only purchases from one supplier because the goods have become less profitable. So they have to innovate in their purchase strategies, production cycle, efficiencies, etc.

Some companies have evolved and are able to be profitable by buying good qualities of rough at a good price from different sources. It’s like the book by Spencer Johnson, *Who Moved My Cheese.*

### Improved Profitability, Transparency Equals “Bankability”

By Martin Rapaport with Avi Krawitz
sources such as the auctions and tenders and on the open market. However, others have not and they have to deal with the change that is taking place in the market in order to survive.

There is less volume being sold at the sights and diamantaires are more cautious about what they buy. Rough prices have come down a bit and diamantaires are taking care not to overstock their inventory. So the second half of 2015 could be better.

The biggest challenge facing the industry relates to consumer demand. I’m not convinced that current levels of demand are sufficient short-and mid-term. I’m concerned that the industry is being forced to cope with its own changes yet it also needs to have a stronger focus on the end consumer.

MR: Is the issue that manufacturers had the discipline not to buy non-profitable rough or have they simply run out of money?
EJ: I don’t think they’ve run out of money. Some smaller companies have cash flow challenges — but that’s not abnormal in times of complicated market circumstances that we see now. However, we ask transparency of our clients in such a case, as we can understand and help them better to pull through. Diamantaires are being more cautious because they’re starting to understand that they need to improve their bankability, which means that they realize that they need to be more profitable and transparent.

There is also a new generation of diamantaires that conduct business in a more modern and corporate manner. The older generation works according to a handshake, which is not conducive to today’s regulatory requirements, although the fact is a handshake and trust are still key ingredients in doing business in modern times.

In addition, diamantaires are more cautious about how they buy because the banks require that they put more of their own skin in the game.

MR: ABN AMRO was among the first to shrink its credit lines to finance 70 percent of rough purchases from 2014. What effect did that decision have on the market?
EJ: It didn’t have a longer-term impact, indeed, but it did not have any abrupt effects. It may have even helped lower rough prices. Our clients reduced their purchases and became more robust by deleveraging the balance sheet.

The policy is in place and we’re absolutely not going to raise our advanced rates. If anything, we may further reduce our financing of rough purchases for trading purposes. We don’t have concrete plans but this has been discussed because trading is more speculative than manufacturing.

We also need to diversify the way financing is made available to different clients. We want to reward the more corporate clients who have the right structure and transparency, good governance and who meet International Financial Reporting Standards (IFRS). We want to motivate clients to be more corporate-like or leave the bank.

MR: Does the lack of liquidity in the market stem from banks reducing their available credit to the industry?
EJ: I don’t believe there is a lack of liquidity. I think there is a challenge in certain areas of the market and in certain locations. But there is liquidity available for good companies.

A lot of companies have moved into a specialized niche or reinvented themselves to be profitable. There are still too many companies that only think about top-line turnover, instead of bottom-line profits. The banks are expected to support them based on turnover but that’s not the way it works anymore. The banks are willing to grow step by step, so I don’t think there’s a liquidity crisis in Israel, Hong Kong, New York, Dubai or Africa.

We have a bit of a challenge in India, where there is a high percentage of nonperforming assets. The regulators are looking at this very closely and asking if these banks are doing the right thing. We also see in Belgium the impact of Antwerp Diamond Bank (ADB) closing, but that also creates opportunities for other banks we see coming in there as well.

So if you run a business that is profitable, transparent and has the right structures, the banks will be willing to finance you.

The question arises why such a large portion of industry financing is concentrated on the middle of the distribution chain. The miners get paid in cash ten days in advance, and don’t give credit to their buyers. Retailers have a lot of inventory on consignment and they buy with 120 days credit. So the problem is not so much overall credit, but the way that financing is distributed throughout the pipeline.

MR: Is the industry over-financed?
EJ: I think the industry could do with less by making sure that people lower their leverage and that they put more of their own money in.

Some of our larger clients have been deleveraging, reducing their balance sheets and lowering their volumes. And they have become more profitable than they were previously. That’s exactly what we want from them. We ask them to focus on profitability and not on turnover. And again, as trusted partner to our clients, we are willing to help them where needed in this process. We are still a service industry to the sector with a client-centric...
approach. A recent survey we did among all our clients shows that on average our clients do appreciate the reform of the industry we try to accomplish with all stakeholders like our clients, but also the Antwerp World Diamond Centre (AWDC), the World Federation of Diamond Bourses (WFDB), The World Jewellery Confederation (CIBJO), the Gem and Jewellery Export Promotion Council (GJEPC), Dubai Multi Commodities Centre (DMCC) and many others.

The banks are willing to support the industry, but they are also short on capital and have to comply with new regulations. So the industry needs to think about other structures, like special purpose vehicles (SPVs), or bring in investors or vehicles such as credit insurance. There are solutions beyond the banks and there should be a shift toward more asset-based secured lending.

**MR:** Is there any danger of companies going bankrupt because the banks are restraining credit, or because banks such as ADB and Bank Leumi are pulling out?

**EJ:** I don’t think so, because ADB is scaling down step-by-step, giving its clients plenty of time to refinance with other banks.

What we do see is individual companies lose touch, or have only one way of doing things and subsequently run into cash flow problems — especially as profitability has diminished. Generally, these companies repay the market first and then the banks, and that affects the trust that the banks have in the industry. There are a lot of good, big companies that are willing to change but there are a few that are ruining the overall atmosphere.

Also, we’re servicing an industry about which the regulators — be it governments, the central banks or the Financial Action Task Force (FATF) — have real concerns.

Despite all the good things that the industry has done, many — including the regulators — still associate the industry with issues such as blood diamonds, smuggling, terror financing, tax evasion or bad labor practices.

Therefore, the diamond industry is rated as “increased risk” by the regulators, which means that businesses have to carry more capital and do additional reporting. So it’s more expensive to finance a diamond company than, for example, a real estate, agriculture or health care company.

As said, we appreciate and support the many initiatives taken to remedy this situation, for instance by the World Diamond Council (WDC), the WFDB and other stakeholders. But you have to ask if it’s enough, because the regulators feel there is still a lot to do.

The industry talks a lot about the need for generic marketing but it should also think in terms of rebranding the industry to improve the perceptions of the banks.

The diamond industry has to move away from that negative brand and toward being part of the jewelry and luxury industries. Doing so and improving its reputation and reporting standards would help negate the perception that the industry is increased risk.

**MR:** What are the banks looking for when assessing their diamond clients?

**EJ:** First, we want to gain a good understanding of the company’s goals, mission and strategy. We also want to understand its ethics in terms of corporate and social responsibility.

Then we go a bit deeper to understand how the company is structured and financed. We look at aspects such as who are the ultimate identified beneficial owners.

We look at the financials, the makeup of its equity and the company’s ratios. Cash flows are important because businesses with cash flow problems tend to face discontinuity. Profitability is very important to our assessment but we also understand that there are periods that

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*Focus on profitability and not on turnover.... The more transparent the company, the better credit rating it will have.*

— Erik Jens
are less profitable or nonprofitable. We pay strong attention to inventory levels and valuations.

We also look at the people involved in the company. It's okay if the business is made up of family members but we like to see, for example, an independent finance department and chief financial officer (CFO) and we also take into account who are the auditors.

The more transparent the company, the better credit rating it will have.

**MR:** Are these measures a result of new regulations governing the banking sector in general?

**EJ:** Our de-risking exercise was initially meant to further control our diamond portfolio. It was also a matter of regaining trust and understanding the reputation of the industry.

However, we were also faced with other constraints. There are new ways for banks to allocate capital as a result of tougher restrictions. The cost of banking has gone up dramatically, especially when you consider the regulations and standards required of banks. The banks and the regulators need to know more from their diamond clients than they do from clients in most other sectors because diamond clients are ranked as “increased risk,” as mentioned earlier.

**MR:** How do you assess risk and what affect does risk have on your book?

**EJ:** There are different types of risk that a bank faces regarding a client: operational risk, credit risk, market risk and reputational risk, and there are different models that calculate those risks. Risk is applied as a percentage of a bank’s outstanding credit and it is then assessed by how well a bank is capitalized.

**MR:** What is your estimate of global bank credit to the diamond industry?

**EJ:** Financing rough diamond purchases has reduced from $15 billion to about $13 billion. I expect that about $4 billion to $5 billion is provided to India and the rest is spread across other centers.

It’s more difficult to assess the extent of credit for polished and jewelry manufacturing because a lot of that lending is being done via the more corporate banks and not through the diamond banking units. The major jewelry manufacturers and retailers, such as Signet and Chow Tai Fook, also have more corporate structures, so it’s difficult to tell.

The total value of the diamond and jewelry business is around $75 billion, so the value creation from diamond and jewelry manufacturing is about $60 billion. But I don’t know the extent of the bank financing there.

**MR:** What would happen if interest rates go up?

**EJ:** Initially there would be a bit of a buffer, since the banks earn a relatively high margin from what they charge the industry. We’ve seen our credit lines going down gradually in the past few months, so people are getting smarter. They will make their calculations with higher rates and decide on either leave goods on the table or slow down their operations or find a different way of financing.

That’s a normal functioning of the market that becomes more difficult to navigate as interest rates go up and volatility rises.

**MR:** Do you expect rough prices to drop given the weak polished market and the unsustainable correlation between the rough and the polished?

**EJ:** I think that rough prices will come down, but not by much because the miners look at their profitability and have their own cash flow challenges. De Beers and ALROSA also have corporate strategies to consider.

The correction should be gradual, as a sharp price decline on rough or polished affects inventory and valuations. So I think we’ll see a bit of a correction on the rough and we’ve already seen a correction on the polished.

**MR:** The problem is if the business becomes profitable again, will the Indian banks rush in with more credit and put fuel on the fire, which is how we got into this mess in the first place?

**EJ:** Everyone has a responsibility. India is a very diverse market with about 60 banks active in the industry. Indian regulators have expressed concern about the high level of nonperforming assets in the diamond and jewelry sector. But I believe there is a concerted effort by the Reserve Bank of India and support from GJEPC to improve the situation. They don’t want a banking crisis in India. Both the banks and our clients there are also realizing that things have to change and that the industry has to deleverage.

**MR:** What are your expectations for the industry for the remainder of 2015?

**EJ:** Hopefully demand will pick up. We don’t expect double-digit growth, but there will be some improvement and that will help reduce polished inventory levels. I think people will have to create more of their own niches and specialities to be profitable. I hope that rough prices will come down, but not too fast, so that manufacturers will gain better profits on rough.

In the lending environment, I think we will see some players reducing their lending and new players coming in. Bank credit is not going to grow fast, but I don’t think there’s a need for credit to increase. I have a relatively good feeling about the banking environment, but if you don’t know what you’re doing, you’ll get your fingers burnt, as in any other industry sector. ✪
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Rapaport Breakfast
Martin Rapaport “State of the Diamond Industry”
South Seas Ballroom, Level 3

10:00/11:30 am
Rapaport Diamond Grading Conference
Banyan B Meeting Room, Level 3

3:00/4:30 pm
Rapaport Responsible Sourcing Conference
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