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## EMBRACE THE DIAMOND INDUSTRY'S RIPPLE EFFECT

# GLOBAL DIAMOND DEMAND FROM THE CUTTING CENTERS MAY DECLINE BY 50%-60% IN 2020!

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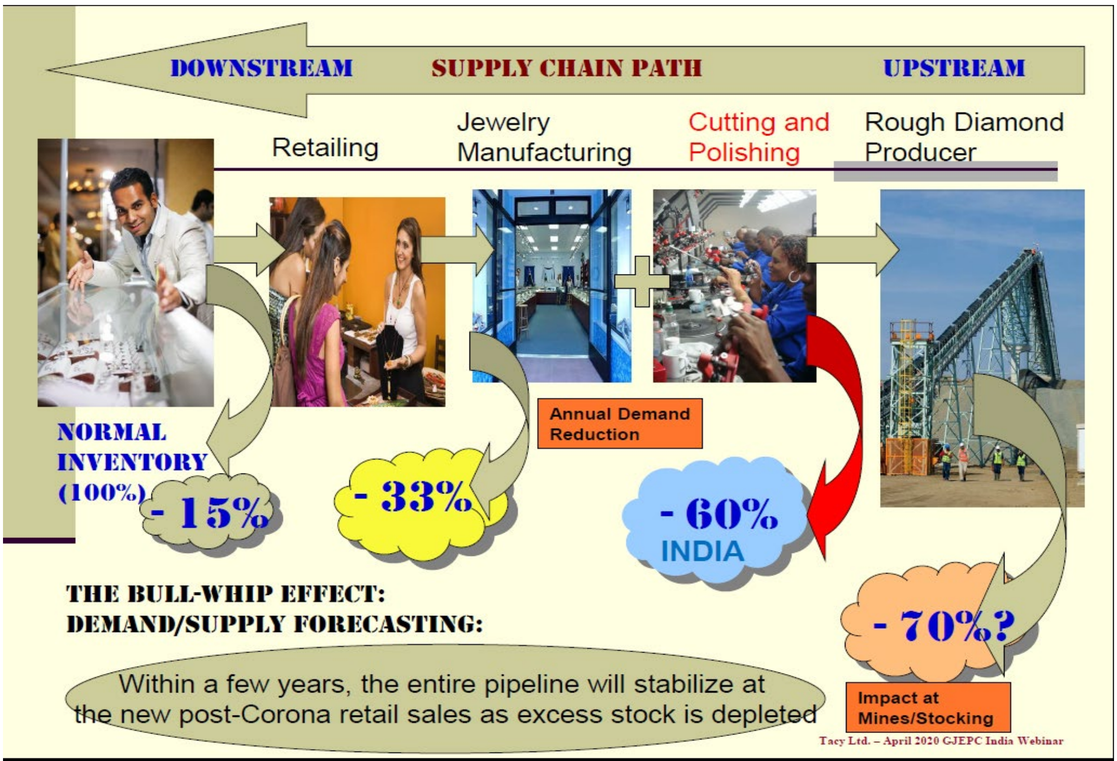
The now inevitable economic slowdown will impact the entire diamond pipeline, but each phase will be impacted in a different way - with the diamond cutting centers taking the more severe beating, only second to the producers. The economic phenomenon that explains with considerable certainty the ways diamond and players are going to be affected is the "**ripple effect**" - a theory that has proven itself over time within our industry.

If diamond jewelry retail consumption **declines by only 15%** by the end of 2020, I think we should consider ourselves extremely lucky. It is likely to be higher. We better prepare ourselves for more. The “destruction” of trillions of dollars globally as a result of stock market crashes and bankruptcies, the enormous unemployment which we will face in the post-Corona area, the recession (if not outright depression) in the United States, the uncertainties about renewal of Corona virus attacks (new peaks in winter), the 10% or maybe higher decline in global GDP, will reduce the level of income and the savings of virtually all consumers.

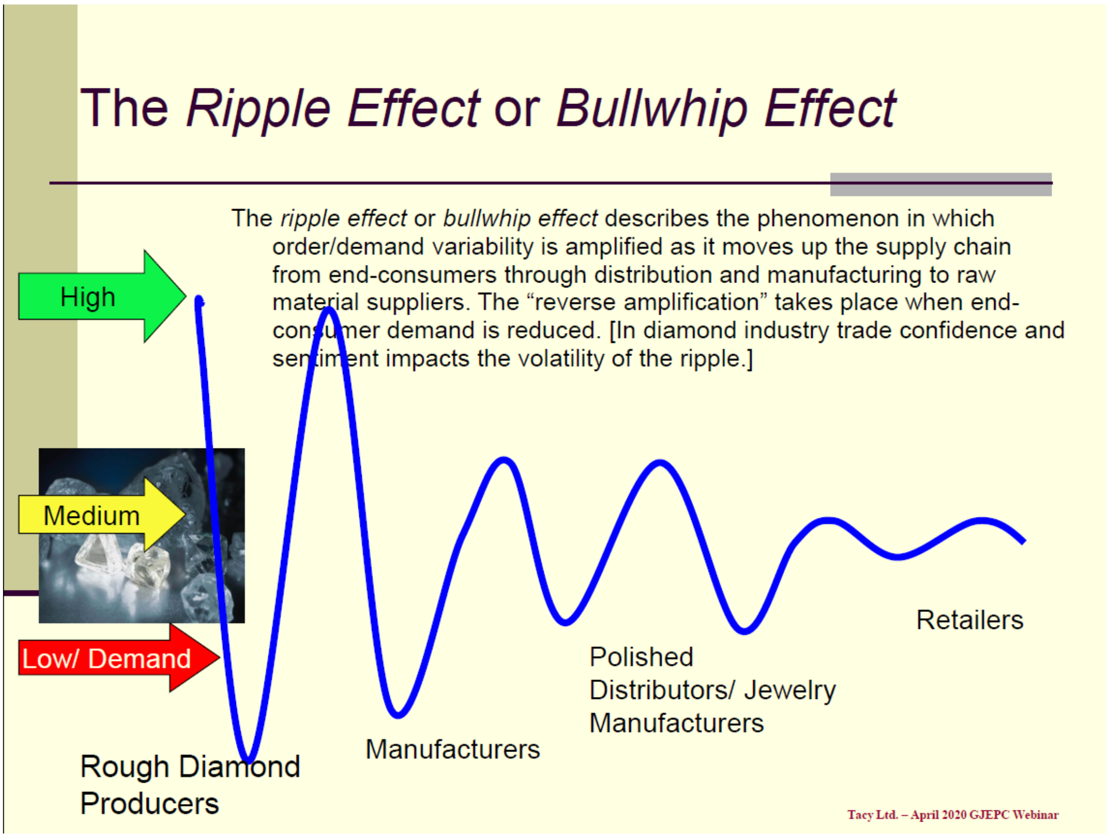
**Excess Disposable Income of Consumers will Fall or Disappear**

The liquidity crunch and economic uncertainties are greater (and globally wider) now than they were in previous crises. The de-stocking by the retail trade and in the jewelry manufacturing sector, the resultant decrease in demand for polished diamonds and destocking in the cutting centers, will have a most severe negative impact on the rough diamond market. We are facing already a significant fall in rough demand, downward pressures on rough prices, shortage of liquidity and reduced pipeline profitability (especially on the level of the producers).

Consumers may not have any money left to purchase luxury items. Diamond jewelry will be impacted. Before explaining how the “ripple effect” (economists also refer to this as “bullwhip effect”) works, allow me a graphic illustration:



Another way to look at the ripple is shown in the following illustration. It shows how a small change (volatility) at the retail level can create enormous wave as the cutting centers and rough diamond production levels:




**How the Ripple Works**

The ripple works both ways - both in a growing and in a falling market. It is premised on the facts that under certain circumstances, increases of diamond retail sales of a few percentage points, let's say 5%, may well trigger a correspondent rise of industry rough diamond off-take of some 15-20%. The reverse may also be true, as we have seen in 2001: a small decline in retail sales, in conjunction with negative trade sentiments, may cause a substantial fall in demand for rough and cutting center polished diamond sales. This occurrence is known as the ‘ripple effect' and the ‘reverse ripple effect'.

How does this phenomenon manifest itself? If it takes an average of 22-26 months for a diamond to move from ex-DTC level to the consumer, this means that the total normal pipeline stock level is US$36-$43 billion (rough and polished, expressed in wholesale polished prices). This figure is of vital importance and means that at the retail level it takes almost one year for the inventory to be turned over (in some places it is slightly shorter).

If consumer purchases of diamond jewelry decline, as we expect will happen in 2020, the need for the retailer to replenish stocks falls accordingly. Depending upon trade sentiment, he will also be satisfied with a lower level of stock. *Thus, a small reduction in retail sales will trigger a far greater decline in the level of replenishment*. These dynamics will be repeated at every intermediate level of the diamond pipeline. **This explains why even a two-three percent decline in the diamond jewelry retail market, coupled with a negative trade sentiment, can cause a 20-30% reduction in cutting center sales.**

This is the ripple effect. Take a hypothetical example (see following table): A retailer whose stock turns around once a year has an opening stock of diamonds of US$100,000. His sales also totaled US$100,000. In the next year, he sells US$120,000, ie a 20% increase on the preceding year. Being optimistic about the future, he wants to have a stock of US$120,000 at the year-end. Consequently, his diamond purchases went up that year by 40%, from US$100,000 to US$140,000.

Now let's look at a different scenario in which the market falls. In the third year, the retailer's sales declined by 10% to US$108,000. Because of his now pessimistic view of the economy, he feels that his stock level should be adjusted in line with his sales volume. In such a year, the retailer's diamond purchases from his wholesale supplier would plummet by a figure much greater than 10% (in this hypothetical view by 31%). What happens in the retail sector also occurs in diluted form at each stage of the pipeline, and this causes steep rough diamond sales fluctuations in the cutting centers.

| HYPOTHETICAL DIAMOND RETAILER'S SALES AND INVENTORY MOVEMENTS | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Year | Opening Stock & Purchases (US$'000) | | Purchase Change (%) | Sales (US$'000) | Sales Change (US$'000) | Closing Stock (US$'000) | Sales Change (%) | Sales/Stock Ratio |
| 1 | 100 | 100 | | 100 | | 100 | | 1.0 |
| 2 | 100 | 140 | +40 | 120 | +20 | 120 | +20 | 1.0 |
| 3 | 120 | 96 | -31 | 108 | -10 | 108 | -10 | 1.0 |
| 4 | 108 | 122 | +27 | 115 | +6 | 115 | +6 | 1.0 |

One of the problems the industry is facing this time around is the suddenness and severity of the economic crisis caused by the Corona pandemic, introducing exacerbating factors. The total standstill of the supply chain. Diamonds cannot move from mine to sorting centers and to sales offices. Half the world is in lock-down. Business has come to a halt at each level of the pipeline.

We are mostly concerned with the industry's "front line": the retailers. In Europe and the U.S. there are already reports about credit lines being slashed - when a retailer doesn't make sales he also will not have the funds to replenish, thus he simply won't. He will have less goods to offer - and will sell even less. A bad year will dampen the retailer's confidence. Whatever happens, given the negative sentiments, he will replenish at significantly lower levels in the year or years ahead.

That's the Ripple Effect at work. As this still early stage we can only quote the stewardess (when we still were allowed to fly) who demanded that we fasten our seat belts and sit tight. We are in for a very bumpy ride.