COVER

A RUN FOR ITS MONEY

How can the diamond and jewelry trade pull out of what many say are dire financial straits? By Anthony DeMarco

It's as if a perfect storm has crashed into the jewelry industry. The problems are well known, and most have been around for a number of years. They include a lack of cash flow, banks pulling out of the industry, bankruptcies, volatile economic and political climates worldwide, strict anti-money-laundering regulations, and lab-grown diamonds. "Disruption" is an overused word, but there's no other way to describe what's happening, according to multiple industry insiders and consultants.

If the problems were of an individual nature, the diamond and jewelry industry could weather this storm. But with everything happening at once and affecting every part of the trade, solutions are few and far between.

"We are at a moment in time in our industry where I feel like crying," says a distraught Bruno Scarselli, a New York-based dealer of fancy-colored diamonds. "The fact of the matter is, the diamond industry has fallen from the grace of God. It's a moment in time when the marketplace is at a point of disruption."

BANK DISTRUST

The combination of diamond and jewelry businesses' excessive reliance on credit, and tough anti-money-laundering legislation throughout the world, has caused banks to pull out of the diamond markets. Western banks were the first to leave, with Antwerp Diamond Bank and London-based Standard Chartered doing so in 2014 and 2016 respectively. For a while, the only banks lending to the industry were in India.

However, in February 2018, jewelers Nirav Modi and his uncle Mehul Choksi were implicated in an alleged $2 billion fraud scheme involving the use of fake guarantees from India's Punjab National Bank to solicit loans. This and other loan defaults may have closed the last source of credit in the industry, delivering a deadly blow to the entire trade and particularly to midstream diamond manufacturers.

Lending to the midstream fell from $16 billion in 2013 to just over $13 billion in 2017, according to Dfin, a London-based corporate finance firm specializing in the diamond sector. It forecasts that loans will drop below $11 billion by 2020. However, there are those who believe the decline will be much greater.

$11B

Loans to the midstream will drop below $11 billion by 2020, according to corporate finance firm Dfin.

"Our numbers show it's actually [going to be] much less than that," says R. Andres Lucas, managing director of the Delgatto Diamond Finance Fund, which provides financing to diamond companies. "By 2022, more than 80% of that original $16 billion will be gone."

"THE DIAMOND INDUSTRY HAS FALLEN FROM THE GRACE OF GOD... THE MARKETPLACE IS AT A POINT OF DISRUPTION"

Ephraim Zion of the House of Dehres in Hong Kong agrees. "The chickens have come home to roost," the jeweler says. "When it was discovered that Nirav Modi stole $2 billion, it raised a lot of flags. The banks have begun to understand that there is a crisis, and a lot of them are demanding their money back."

He predicts that "in the next couple of months, especially in India...there will be a lot of companies going out of business. They're going to dismiss thousands of workers."

But for banks, the damage from diamond industry bankruptcies is more than monetary, notes Lucas, who was a veteran hedge fund manager before he joined Delgatto. While "$16 billion loaned to a space by commercial banks at a peak is a low amount of money overall," he says, "the reputational risk is much higher. When a diamond company goes bankrupt, it lands on the front page of the newspapers. If it's a construction company, nobody cares."

One little-discussed issue is the lack of credible data records in the diamond and jewelry sector. With so much of the trade consisting of small family-owned companies, which are under no obligation to publicize their financial statements, it is difficult for banks to evaluate the state of the industry.

"That's another reason why banks are cautious about lending," says industry consultant Peter Meeus, who formerly served as president of the Dubai Diamond Exchange and director-general of the Antwerp World Diamond Centre.

CRACKDOWN ON CORRUPTION

Meanwhile, anti-money-laundering requirements have tightened throughout the world, with the United States leading the way. For example, cash transfers from certain countries, such as Russia and China, are coming under greater scrutiny than in the past. This is a drawback for an industry that does a lot of its business in cash, since the money can take weeks to clear and some banks prefer not to deal with the new regulations at all.

"Some countries have worse standards than the US," Zion reports. He points to Hong Kong, which toughened its standards after receiving an unfavorable assessment from the Financial Action Task Force — an intergovernmental organization that develops policies to combat money laundering.

Scarselli experienced the change in policy firsthand with his company's ▸

4% The number of jewelry retailers, wholesalers and manufacturers in the US and Canada fell 4% in 2018

Hong Kong office. "For 15 years, I had an account in Hong Kong with HSBC [the municipality's largest bank]. Overnight, they asked us to leave."

Zion adds, "I'm in Israel right now and it's the same thing. If you walk into a bank and want to open an account, it's almost impossible. It's absolutely ridiculous."

The problem, he continues, is that they are treating everyone in the diamond industry the same way. "They went too extreme, and it is already hurting the industry. More than 95% of those in the industry are law-abiding, respectful people who do things the right way. The majority of diamond dealers and manufacturers, unfortunately, have been painted with one brush as high-risk, and this is extremely unfair."

FEELING THE SQUEEZE

In the US, the long-term trend of jewelry-business closures and bankruptcies continues. In 2018, the number of jewelry retailers, wholesalers and manufacturers in the US and Canada fell by 4% to 26,365, according to the Jewelers Board of Trade (JBT). The retailers alone declined by the same percentage to 19,906.

Manufacturers, retailers and dealers in the US are facing the same issues as everywhere else, but with the added challenge of changing consumer tastes, says Robert Hoberman of the Hoberman & Lesser accounting firm in New York, whose clients include jewelry companies.

"Millennials don't have the same love for jewelry that baby boomers and the Greatest Generation (those who came of age during World War II) had," he says. "They bought jewelry for milestone significant events. Besides engagement rings and wedding bands, they purchased tennis bracelets and other jewels to mark an occasion."

However, he continues, "the marketplace in the US changed fairly significantly with increased competition [via] the Internet. Anyone with a computer and cell phone can look up diamond prices on RapNet and [e-tailer] Blue Nile. It not only leveled the playing field, but caused margins to be reduced significantly."

Margins are definitely a big problem in the industry, and there are a number of reasons for it, according to those interviewed. First, mining companies are refusing to lower their prices. Midstream manufacturers, which are bearing the brunt of the squeeze from the lack of bank funding, are being forced to sell more

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diamonds at lower prices, thus flooding the market and reducing prices further.

"Rough producers not reducing their prices are forcing others to sell at prices where people need to take a loss," Meeus says, adding that he believes lab-grown diamonds are affecting prices as well.

DIGITAL SOLUTIONS

One of the major causes of the industry's challenges could also be a cure for what's ailing it, according to Hoberman.

"The internet brings forth problems and opportunities," he says. "People who can successfully market their goods on the internet and social media to clients are probably going to be more successful than people who rely on the old methods of friends of customers and word of mouth. Keep your website and social media updated. Close every sale aggressively online. Hopefully you can get the customer into the store, but you can close a sale without ever seeing the customer."

There are some creative solutions in the works. For example, Scarselli has teamed up with Erik Jens, formerly of Dutch bank ABN-AMRO, to create a blockchain-fintech product called DiamHolding. Using nanotechnology, the company can insert a "nano-tag" deep within a polished diamond, containing all of the stone's details. The information is registered in a blockchain database, and a smartphone application can track and retrieve the tag's data — an arrangement Scarselli believes will be attractive to tech-savvy consumers.

This would help solve the problem of ownership, traceability and product integrity as a polished diamond travels around the world. But Scarselli's and Jens's plans are much bigger. They want to turn these tagged diamonds into collateralized investment vehicles, or bonds, that can be traded in the financial markets. They are in the process of acquiring patents for the app and financing platforms, which incorporate artificial intelligence, voice recognition and computational photography along with nanotechnology.

"The principle of the patent is to be able to turn diamonds into fungible assets," he says. "They can be collateralized with a type of paper that can be sold in the marketplace. The other aspect of the patent is to create a solution that is smartphone-based."

Scarselli sees this as a way to restore liquidity to the diamond industry, with the bonds creating an additional revenue stream that will strengthen the trade.

TURNING ELSEWHERE

The Delgatto Diamond Finance Fund is another example of a company seeking to offer alternative financing. Started by Chris Del Gatto — who made his name in the industry as the founder of luxury estate jewelry business Circa — the company primarily provides collateralized loans. Jewelers have to put up inventory equal to the amount they borrow in order to receive the loans. They can then opt to sell the jewels on the website I Do Now I Don't, which Del Gatto also owns, and those sales go toward repaying their debt.

80% By 2022, lending to the midstream will have slid more than 80% from the 2013 figure of $16 billion, predicts R. Andres Lucas of Delgatto

The company also provides other services, Lucas says, including consulting to help businesses manage their finances. It will soon roll out basic banking services for the diamond midstream and jewelry manufacturers, he adds, such as checking and debit cards and a basic framework for wiring money.

On a broader level, Zion believes mining companies need to be more involved in the solution, and that begins with limiting the supply of rough to the trade.

"One of the major problems in our industry is that there is an imbalance between supply and demand. Demand is weak, while the supply of large diamonds is increasing. Until this overhang is addressed, there is no chance in hell our business will be healthy again," he asserts. "If the mining companies stop putting so many large diamonds into tenders, then we have a chance of recovery. But they're not. This is a very important issue. We get invitations from all these miners to participate in tenders, and there are so many big diamonds, it's scary." ■

CASH ON HAND

Cutting costs is better than relying on credit, says Mariel Diaz, founder of Accounting for Jewelers

Over-leveraging is the biggest problem Mariel Diaz has encountered among jewelry businesses. "Usually they overextend themselves, because either investors believe in them, or they are depending too much on credit and buying too much inventory," says Diaz. "Payroll is another big problem."

Her Nashville, Tennessee-based accounting firm, Accounting for Jewelers, has about 50 full-time clients in the jewelry retail, wholesale and e-commerce sectors, and another 100 or so on an as-needed basis. Diaz advocates basic and common-sense solutions that, if implemented properly, can effect a powerful turnaround for struggling businesses.

"Cash in the bank is always a good thing," she says. "Cutting costs has the greatest long-term impact." She recommends "taking a percentage of all sales and using it as savings for future expenses. Setting money aside so you have funds for big inventory purchases each year and hiring staff, instead of paying more for those things by [using credit, which entails] interest."

Inventory and people are the two areas where businesses often pay too much, she has found, whether it's overbuying stock, spending too much on salaries, "or just not holding salespeople accountable [for showing] a return on what they're being paid."

Put simply, she says, "it's important to just try to keep your costs low. It doesn't matter how much these businesses make or whether they are small or really huge. The most important thing is what they do with what they make."

One thing she doesn't advocate is getting loans. "I know it's the quickest way to scale and grow, and sometimes it can't be avoided, but definitely plan ahead for a new website or marketing effort."

Her advice in a nutshell: "First, identify future goals, and then set money aside for those goals from current income so you do not have to rely on credit."