Alternative Funding for the industry's Midstream

Varda Shine

Antwerpen, 6th September 2018

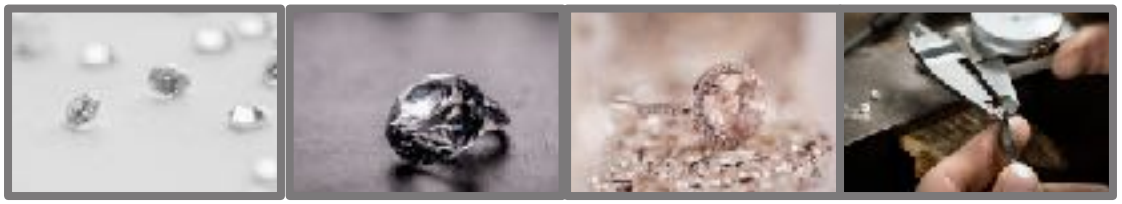
Funding the industry's Midstream: some context

The Past

- The historic role of Retailers
  - ✓ For most of the 20th century, retailers' purchasing and inventory management played a key role in midstream financing
  - ✓ In the late 90's, many retailers moved purchase to memo arrangements with diamond suppliers
  - ✓ In addition, retailers, more generally, reduced their appetite to hold stock, requiring the midstream to hold inventories (JIT)

- The role of De Beers prior to 2000
  - ✓ Throughout the 20th century, De Beers stockpile played a major role in supporting the midstream finance requirements
  - ✓ De Beers business model changed, the stockpile was sold down between 2000-2004, moving the finance burden to the midstream

- Traditional banking
  - ✓ Diamond banks have been in Antwerp from industry's inception
  - ✓ New banking norms were introduced (Basel, AML/TF, KYC etc)



Funding the industry's Midstream : Trends and Challenges

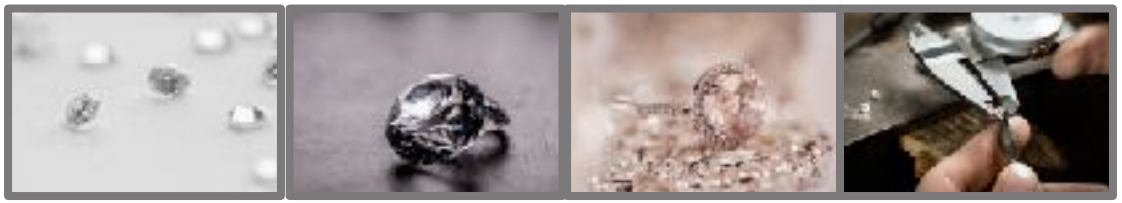
Reasons for Changes in Financing Activity

- The greater demand for financing at the time banks require:
  - ✓ Increased capital
  - ✓ Higher charges for banks
  - ✓ Higher sensitivity to compliance and reputational risks than before
  - ✓ Transparency. The industry still being perceived as not being transparent despite adoption of regulations and best compliance practices
  - ✓ More solid collateral
  - ✓ Visible Growth in sector

Other Challenges

- In addition to the scarcity of financing, the industry is also facing challenges to obtain traditional banking services (e.g. bank accounts)

- However, traditional banks remain important to the industry as they are able to provide revolving credit facilities while non-bank institutional investors typically prefer financings with fixed notional terms.

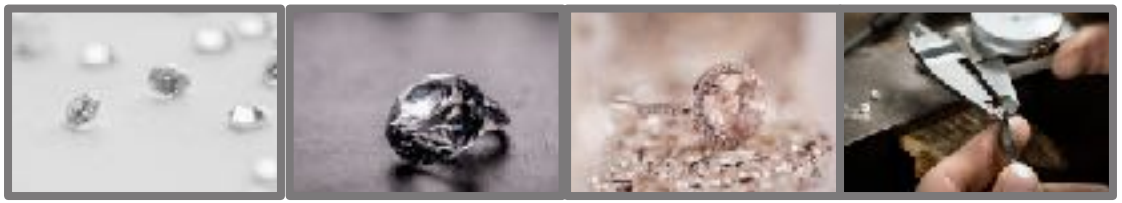


Funding the industry's Midstream : Trends and Challenges

Reduced Financing Activity by Traditional Banks

- Financing activity by traditional banks to the midstream diamond industry has been declining in the past few years:
  - ✓ Antwerp Diamond Bank's activities have been winding down since 2014
  - ✓ Standard Chartered Bank decided in 2016 to exit the diamond and jewellery lending business after incurring significant losses
  - ✓ Other banks such as Bank Leumi have discontinued their midstream diamond financing activities
  - ✓ Indian banks have also started reducing the amount of credit granted to the midstream diamond industry in light of the Nirav Modi fraud. There has been at least a 10% decline in bank finance to the gem and jewellery sector over the past few months (*GJEPC: Banking Finance Support to Gem and Jewellery Declines by 10 Per Cent in Q1, 24th July 2018*).
  - ✓ Union Bank of India latest announcement

- An estimated $3-4 billion credit gap is likely to emerge in the sector by 2020 (*Natural Resources Forum, Financing the Stone: Capital Markets, Banks or Fintech?, November 2017*).



Funding the industry's Midstream : Opportunities and New Initiatives

Emergence of New Players

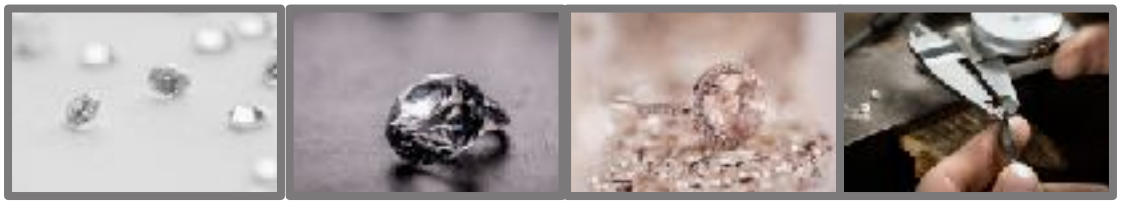
- The difficulty of the diamond midstream industry in obtaining financing and banking services from traditional banks has led to the emergence of new players such as London-based Channel Capital Advisors LLP (**"Channel"**) and others.

- Channel has brought to the midstream diamond industry several hundred million dollars of financing from non-bank institutional investors by creating a legally robust financing programme and bringing in experienced originators, structurers, risk and operational managers to originate, structure and manage financing programmes for leading diamantaires.

- Other companies, such as Guggenheim Investment are getting into the midstream funding

Further Initiatives

- Other diamond industry participants have launched initiatives to address the dearth of credit to the industry and the increased difficulty in obtaining banking services:
  - ✓ AWDC launched a pilot project launched with Ebury, a UK-based fintech company. This resulted in the creation of bank accounts for a small number of diamond traders in 2018.
  - ✓ AWDC started investigating the possibility to set up its own payment platform for the diamond industry.
  - ✓ AWDC and the Gems and Jewellery Export Promotion Council have announced they will join forces in rolling out an industry-wide Know-Your-Customer (KYC) exchange platform, MyKYCBank. The platform's aim is to bring greater transparency to the diamond industry and make regulatory compliance more efficient by helping with the due-diligence process. Users can share KYC data with other companies located in Antwerp and India, banks, and other financial institutions.
  - ✓ Some traditional Banks came recently into the industry (at limited amounts)



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Securitasation of Receivables and Diamond Inventory

- Securitisation is the sale of various types of assets and/or debt by a seller to a special purpose entity (SPE). This sale is financed by the SPE issuing bonds to (and/or borrowing loans from) investors (e.g. banks, insurance companies, HNW individuals etc.).
  - ✓ Unlike secured lending, a securitisation involves the sale of assets by the seller to the SPE. If the sale is performed in the correct manner (i.e. the sale is a "true sale"), the assets will no longer form part of the seller's estate thereby protecting the SPE in the event of a bankruptcy of the seller
  - ✓ A securitisation is typically a limited recourse financing, i.e. the SPE's claim is limited to the assets sold to it by the seller and not from any of the seller's other assets
  - ✓ The sale of assets is typically subject to a borrowing base test which compares the amount of assets owned by the SPE to the amount of debt owed by the SPE

- Diamond traders and manufacturers have been able to access new sources of financing by selling their trade receivables and/or diamond inventories to SPEs such as Luxembourg-based Channel Finance S.A.. The financing works as follows:
  - ✓ The SPE purchases eligible trade receivables and/or diamonds from the seller, on a revolving, true sale and limited-recourse basis
  - ✓ The SPE funds the purchase of the receivables and/or diamonds by issuing bonds to or borrowing loans from institutional investors as long as certain conditions are met, in particular the compliance with the borrowing base test
  - ✓ During the revolving period, collections (i.e. customer payments of receivables or sales of diamonds by the seller to its customers) are used to purchase new receivables or new diamonds
  - ✓ At the programme maturity date all collections are used to repay the bonds and loans
  - ✓ The seller continues to service and administer the receivables and to manage the sale of the diamonds

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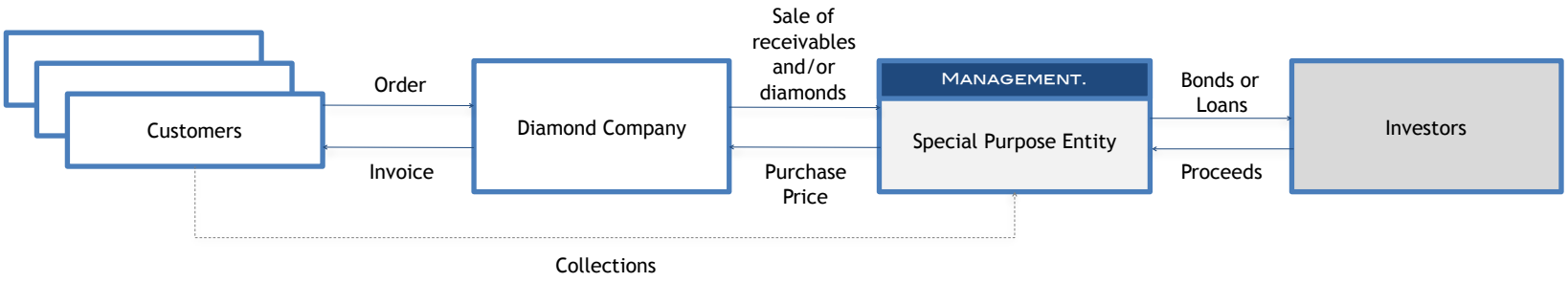
The Flow



Insurance
Legal agreements
Credit policy
Transparncy

Insurance
Rating agency
Legal agreements
Issuing a bond

Insurance
Legal agreements
Risk Committee
Investment Committe

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Other options

- Purchase Funding
  - ✓ Revolving funding of a producer "sights", providing partial funding for 2-3 sights
  - ✓ Multi clients fund that will have some securitisation against rough purchases. Algorithm for fair distribution of the funds will be required.
  - ✓ Advance rate of 80%-90% of purchase paid.
  - ✓ Institutional Investors deem this riskier and therefore require greater return, which makes it too expensive at the moment.

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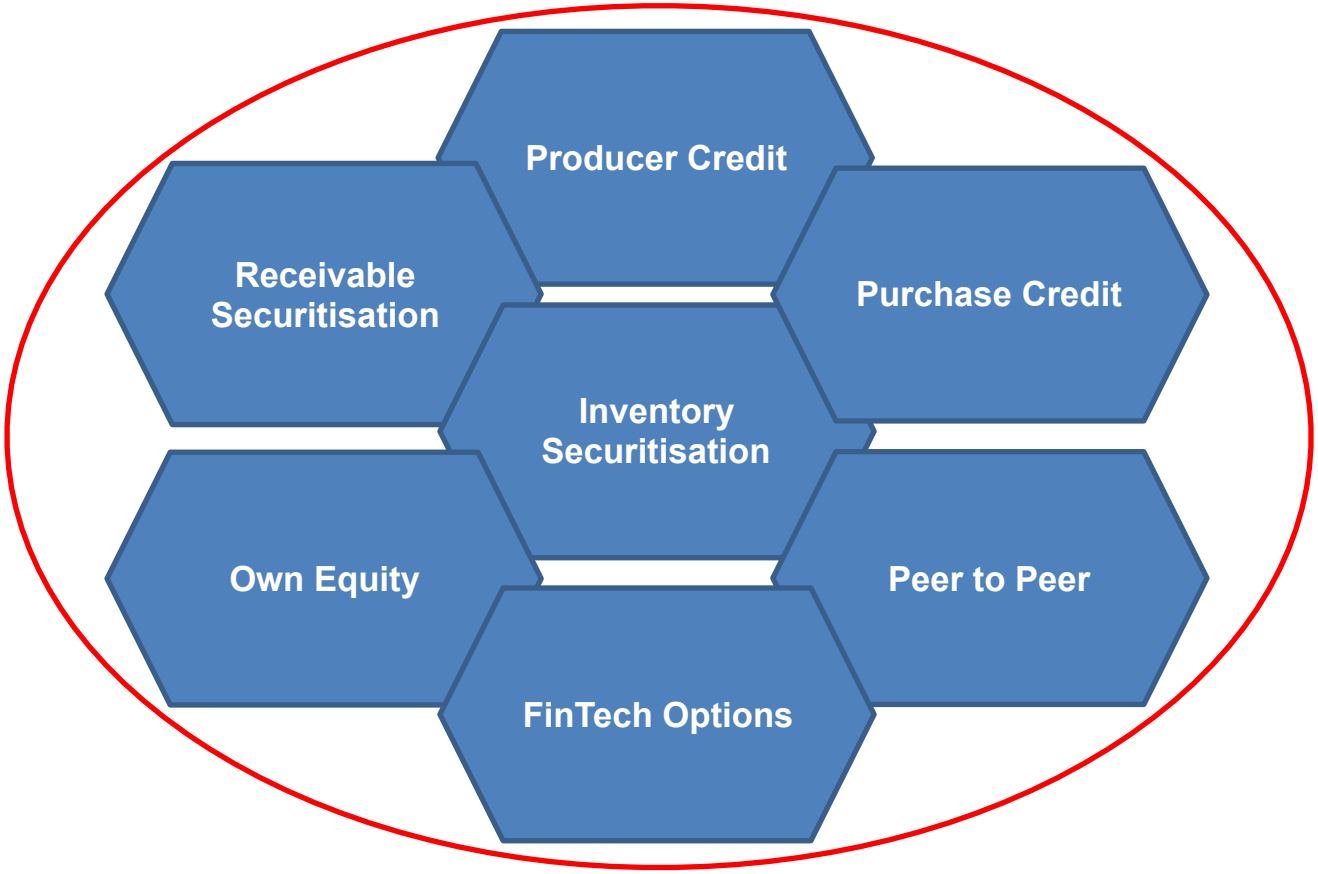
What the Future may look like…



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