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Middle East green finance

A US$2 trillion opportunity

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EXECUTIVE SUMMARY

Green finance represents a significant, and currently untapped, opportunity for the countries of the Middle East, in particular the Gulf Cooperation Council (GCC)[1] countries, which have well-developed capital markets. Investors around the world are pouring capital into projects with a strong environmental, social, and governance (ESG) angle, precisely the area in which the GCC countries have an advantage because of their abundant and low-cost renewable energy. Our analysis has found that green investments in six key GCC industries could have a profound impact by 2030, unlocking up to US$2 trillion in cumulative GDP contribution, creating more than 1 million jobs, and encouraging foreign direct investment (FDI).

To capitalize on this opportunity, and continue the process of diversifying regional economies away from fossil fuel–based industries, governments in the region need to focus on four priorities: promoting environmental sustainability; creating a green sovereign wealth fund; strengthening capital markets; and developing standard and transparent reporting mechanisms for environmental performance.

THE GREEN FINANCE OPPORTUNITY

Governments and businesses in the GCC are devoting significant attention and capital to environmental sustainability. However, until now the financial sector has not kept pace. Green finance, which takes into account the environmental impact of investments in addition to purely financial returns, remains relatively underdeveloped. That needs to change, because developing the right structure and mechanisms for green finance can help unlock a significant opportunity for the GCC region: $2 trillion in economic growth and more than 1 million jobs by 2030, according to our analysis. Moreover, green finance can accelerate the region's goals of economic diversification and job creation. If structured correctly, it can attract FDI.

To capture this opportunity, GCC governments should focus on four priorities: promoting environmental sustainability; creating a green investment body; strengthening capital markets; and developing standard and transparent reporting mechanisms for environmental performance.

The environmental sustainability imperative

Sustainability is becoming the main societal priority around the world. Mainstream financial institutions today make investment decisions only after carefully studying environmental, social, and governance (ESG) risks. The world's largest asset managers, insurers, and stock exchanges are redirecting massive amounts of capital to sustainable investments, with profound implications for governments, investors, and companies. In the E.U. and the U.S., investors poured a record $156 billion into sustainable investment funds in 2019, nearly triple the previous year's amount. At the same time, traditional industries with harmful environmental impacts are struggling to attract capital.

To get ahead of this trend, major private-sector players such as Amazon, Delta Air Lines, Microsoft, and Unilever have committed to becoming fully carbon-neutral in the next 10 to 20 years.[2] BlackRock, holding over $7 trillion worth of assets under management, recently announced that it would exit any investment with a clear sustainability risk.[3] Even bulwarks of the hydrocarbon-fueled economy, such as oil and gas companies, are starting to transition from carbon-based energy to renewables and are announcing net-zero commitments. BP, for instance, revamped its planning processes and will increase the price of carbon by 150 percent, from $40/ton to $100/ton, by 2030. The company aims to achieve 50 gigawatts of renewable energy capacity by 2030. Both BP and Shell have pledged to reduce the carbon intensity of the products they sell by 2050—BP by 50 percent and Shell by 65 percent.[4]

Furthermore, research has demonstrated a positive relationship between ESG performance and financial returns. A 2017 study by Nordea Equity Research found that between 2012 and 2015, companies with higher ESG ratings outperformed companies with lower ESG ratings by up to 40 percent, in terms of returns to investors and other financial metrics.[5] Additional studies conducted by Harvard Business School and Bank of America have found that firms with strong ESG performance are likely to produce higher returns than their peers.[6]

In recent months, several leading global governments have announced zero-emissions pledges. In the U.S., the Green New Deal proposes achieving net-zero greenhouse gas emissions across the economy by 2030, although the plan has not been adopted.[7] The E.U.'s 2050 long-term strategy details a plan for net-zero greenhouse gas emissions within the next three decades.[8] Germany specifically launched a stimulus package to help its economy emerge from the COVID-19 pandemic in a more climate-friendly manner. The country will invest grants worth over $55 billion into sustainable mobility, energy transition, digitization, and research and education projects.[9]

For GCC countries, green finance can help address the recent declines in FDI. In previous decades, the GCC could attract foreign investors seeking low-cost hydrocarbons for sectors such as petrochemicals and refining. As ESG scrutiny has increased, investors' appetite for those industries has declined proportionally, leading to a drop in FDI. Measured as a percentage of GDP, such investment into the GCC has declined by about 40 percent over the past decade, according to the World Bank.[10]

By shifting their mindsets to view sustainability as an opportunity rather than a burden, GCC executives and investors can unlock significant opportunities for economic growth, industrial development, and innovation.

The regional advantages in renewable energy and project financing

To diversify economic activity, the GCC countries must capitalize on their competitive advantage of low-cost renewable energy resources. Two fundamental features of the region's energy supply system explain this potential: ample, high-yield renewable resources and a bankable model for private investment.

Located in the heart of the global sunbelt, GCC countries have some of the highest solar exposures in the world. According to a Strategy& analysis, solar power plants in the region can expect 1,750 to 1,930 hours of full-load operation per year. A solar-photovoltaic panel in a GCC country produces twice as much output as it would in Germany or any climatically similar European country.[11] The region also has areas with high-velocity wind resources. Overall, the cost of producing solar, wind, and green hydrogen in the region is about one-third that of the global average.[12]

In addition, the GCC has a well-established model of privately financed power generation assets, with a two-decade-long track record of stability and success. The GCC has several best-in-class project developers that understand the characteristics of renewables financing. They grasp that the cash economics of a renewables project differ from those of a fuel-consuming, conventional power project. Renewables have mostly up-front, one-time costs during construction, and negligible ongoing operations and maintenance costs, in contrast to the large ongoing maintenance costs of conventional power. These developers understand the technology and the market. They have a knack—and an appetite—for turning long-term risks into bespoke credit products for commercial lenders.

Quantifying the opportunity

We looked at six major non-oil sectors in the GCC to quantify the benefits of green investing in terms of economic diversification and growth. These were agriculture and food, construction, power, transport, water, and waste management. We estimate that the cumulative GDP contribution of these sectors can reach $2 trillion through 2030. With the expansion of these sectors, we estimate the GCC countries could add over 1 million jobs by 2030.

For example, in the agriculture and food sector, governments can take steps to restructure supply chains, safeguard imports, and make the overall sector more sustainable—a critical need following the COVID-19 pandemic. Today, GCC countries recycle, reuse, or recover only around 10 percent of plastic and metal waste, resulting in significant waste.[13] Increasing recycling rates in the GCC to an achievable 40 percent would create about 50,000 new jobs to support a $6 billion market. Investors in the sector can expect healthy operating margins of above 15 percent in various opportunities across the value chain, such as waste electrical and electronic equipment recycling, plastics and packaging recycling, secondary metal semi-finished producers, or car spare parts manufacturing.

Similarly, in the power and construction sectors, governments can unlock the most value through a combination of low-environmental-impact hydrocarbon resources and low-cost renewable resources. Further, they can consider using the region's abundant renewable resources to manufacture carbon-neutral, or even carbon-negative, industrial products for export.

Green hydrogen is a clear opportunity. Production technology for green hydrogen is easily accessible, reducing the barriers to entry. According to our global supply and demand analysis, exporting countries can potentially capture a market of approximately 200 million tons of green hydrogen by 2050, worth $300 billion yearly. The green hydrogen export market can also create up to 400,000 operations and maintenance jobs.[14] Supported by the right investments, GCC countries can take advantage of their high-yield renewables, ample usable land, ready access to seawater, and low domestic consumption in order to maximize their export potential.

Another promising sector is transport. GCC governments can develop smart charging infrastructure for electric vehicles (EVs). In addition to reducing emissions, EVs save money and introduce renewables into the overall energy mix. Smart charging infrastructure can accelerate EV adoption and can be powered through the region's abundant, low-cost renewables.

The region can lead the world in dealing with water scarcity, a particular problem for the GCC, by building the world's first low-carbon urban water utility. Such a utility would reduce wastewater discharge by treating wastewater through a full-resource-recovery approach, thereby reducing the need for more energy-intensive sources of water such as desalination or the treatment of brackish water. The utility would use more energy-efficient treatment technologies like reverse osmosis and would rely on renewable energy sources including solar photovoltaic and wind.

Additional opportunities for green finance

In addition to the six sectors in our analysis, GCC governments can seek opportunities in other areas. For example, they can encourage sustainable tourism, demand for which has increased significantly over the last decade. A growing number of travelers seek authentic cultural experiences and activities such as cycling, hiking, and road trips.[15] Green financing opportunities in tourism could support the construction of resource-efficient tourism infrastructure, including eco-friendly hotels and natural heritage destinations. In Saudi Arabia, for example, the government has been collaborating with the agricultural sector to offer holidays on farms. Similarly, Oman and the United Arab Emirates (UAE) have made efforts to preserve biodiversity and further develop eco-tourism offerings.

FOUR STRATEGIC PRIORITIES

GCC countries have already begun the transformation to sustainability. The question now is how they can support these initiatives in a differentiated manner and capture the largest share of the economic prize. Four strategic priorities should be on the agenda of all governments in the region.

Promoting environmental sustainability

Governments should enact policies that promote environmental sustainability in all industries, including incentives, market mechanisms, and standards. Market mechanisms such as fees on carbon, plastic, and other materials with harmful environmental impacts provide a true cost of a company or industry's activities. Incentives in areas such as renewable energy usage and electric vehicles can boost adoption.

Governments also need to continually update regulatory standards for emissions, recycling, and building codes to ensure the economy is keeping pace with advances in innovation and technology. Furthermore, governments can phase out existing inefficient subsidies for electricity, fossil fuels, and water. When such subsidies are poorly targeted, as has often been the case, they promote wasteful consumption of resources, economic distortion, and harmful environmental outcomes.

Creating a green sovereign wealth fund

Each GCC government should create a green sovereign wealth fund. This organization should have the credibility and capabilities to engage with, and attract, international investors. The green sovereign wealth fund should not be beholden to the region's legacy mindset regarding sustainability, which treats it as a cost burden, rather than an opportunity. Establishing a green sovereign wealth fund will unlock substantial benefits to all stakeholders, including the public sector, investors, developers, and the general public (*see Exhibit 1*).

EXHIBIT 1

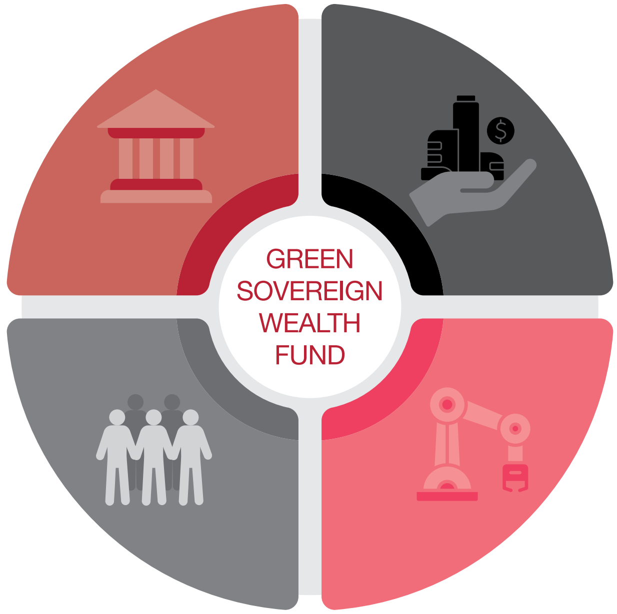
Creating a green sovereign wealth fund

PUBLIC SECTOR

- Speeds up achievement of environmental targets
- Frees up finances from public investment entities
- Acts as a green branding tool for the country

INVESTORS

- Allows for high investment returns
- Provides opportunity to contribute toward an environmental cause
- Improves public image and increases media coverage



GENERAL PUBLIC

- Creates employment opportunities
- Contributes to healthier living

DEVELOPERS

- Allows for better lending terms
- Provides credible certification
- Allows for a wider range of investment opportunities

Source: Strategy&

Most importantly, this green sovereign wealth fund should act as a credible minority partner attracting international and local private investors, rather than keeping them out. The right approach is akin to seed capital—governments that create the right environment for green finance can invest a small slice of the required capital and attract the remainder from institutional investors and other players from around the world. Indeed, a leading government-owned green bank managed to draw 11 times the government's stake in equity from private players.

In addition, proceeds including asset sales, dividends, and interest payments are subsequently being recycled and reinvested. Sustainable investments have garnered relatively solid performance, and returns from equity and debt investment made in green funds have proven to be comparable to those of conventional indices. An analysis comparing the financial performance of the S&P 500 Index to the S&P 500 ESG Index shows that during the five-year period through March 2019, the sustainability benchmark provided an annualized return of 8.8 percent, compared with the S&P 500 Index's 8.2 percent return. Furthermore, the S&P 500 ESG recovery in 2020 outpaced that of the S&P 500 Index.

In creating such a fund, it is critical to strike the right balance between environmental impact and financial performance and risk. Determining the portfolio focus and the sectors to invest in, defining what risk profile to adopt, and identifying the types of investments require an in-depth analysis of local needs, regulatory requirements, and international best practices. They also require a rigorous investment process, robust financial tools, and strong internal capabilities (*see Exhibit 2*).

EXHIBIT 2

Strategic options for the green sovereign wealth fund

Promote local content first	Local	GEOGRAPHY	Global	Focus on impact first
Focus on one industry	Specialized	PORTFOLIO	Diversified	Diversify into energy, buildings, transport, water, and waste
Invest in power sector or electrification	Conventional	SECTOR	Innovative	Invest in decarbonization or digital
Enter into mature investments	Low	RISK PROFILE	High	Enter into venture capital investments
Provide credit guarantees	Support	INVESTMENT VEHICLE	Financing	Provide funding
Identify projects individually in-house	Low	PARTNERSHIP	High	Utilize market platforms

Source: Strategy&

Strengthening capital markets

GCC governments should continue opening up, and strengthening, the region's capital markets. A key constraint of the current environment for green finance is that these capital markets are relatively underdeveloped. Building up these capital markets will allow investors to exit successful investments easily. In addition, it will help investors access GCC funds, such as those held by high-net-worth individuals and families.

Governments can take several steps to build local capital markets. They can increase the number of attractive sustainable investment opportunities by privatizing—either partially or preferably fully—assets across the region, drawing international retail and institutional investors. Governments can also increase the demand among local retail investors by incentivizing stock market investments in the region. That would, in turn, promote a savings culture and discourage expatriates from moving financial resources overseas. Pooling demand across today's fragmented exchanges can increase liquidity. Each GCC country has at least one stock exchange; the UAE has three. Creating a pan-GCC exchange, or standardizing formal linkages among individual exchanges, would be beneficial.

Green bonds are another option for maturing capital markets. Such bonds are reserved explicitly for projects that deliver environmental benefits and a more sustainable economy. Since 2007, when the first green bond was issued by the European Investment Bank and the World Bank, the market has surged, to reach over $800 billion worldwide in 2021.[16] Green bonds have significant room to grow in the Middle East, as the region made up just 0.3 percent of the global market in 2021.[17] To capitalize on the opportunity in green bonds, governments need to craft regulations and establish tax and other incentives for capital providers.

Developing standard and transparent reporting mechanisms for environmental performance

GCC governments must build comprehensive, standardized, and transparent reporting systems for green finance. Clear measurement and reporting mechanisms are a complex challenge for sustainability initiatives worldwide. Investors are demanding information of higher quantity and quality, yet companies are not obligated to disclose ESG achievements. When they do, they often adopt standards that are globally fragmented, making objective comparisons difficult. Another challenge stems from lack of data reliability and verification, due to self-assessment and reporting.

Given these difficulties, systematic regulation and validation frameworks can help governments maintain the credibility of their sustainability agenda and allow investors outside the region to judge the performance of sustainability initiatives objectively. Reporting indicators and mechanisms need to be tailored to regional capabilities. Moreover, governments in the region are unlikely to solve these problems on their own. They will make faster progress by collaborating proactively with the international organizations already working to develop ESG accreditation and reporting.

CONCLUSION

GCC governments have made some headway in transitioning away from carbon-based industries, diversifying their economies, and stopping the decline in FDI. They can do far more by capitalizing on their advantages in renewable energy and embracing green finance.

ENDNOTES

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