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ESG in GCC: Practical issues to think about

Research Highlights:

This report deals with the practical aspects related to ESG implementation in the GCC region. It also touches upon the recent efforts taken by the governments in this regard and the benefits resulting from ESG based investing.

About Marmore

Marmore MENA Intelligence is a fully-owned research subsidiary of Kuwait Financial Center 'Markaz'. Since 2006, Markaz Research has been at the forefront in disseminating thought-provoking, hard-data backed research reports. Marmore continues that legacy with a focused approach to providing actionable solutions for business leaders and policymakers.

Since its inception, Marmore has published over 700 research reports and covered more than 25 varied industries and infrastructure segments; all focused primarily on the GCC economies. (To view our Research Library, please ***click here***)

With over 30 policy and regulatory research studies published, Marmore has partnered with renowned regional think-tanks and opinion-leaders to publish some of these intellectually provoking policy research papers. These research studies aim to initiate dialogue and propose better solutions to existing economic conundrums. (To view our Policy & Regulatory research report, ***click here***)

Marmore provides research-based consulting solutions to help understand current market conditions, identify growth opportunities, assess supply/demand dynamics, and make informed business decisions.

Almost on a weekly basis, Marmore publishes thematic economic, industry, policy and capital market reports. Marmore has been recently conferred **"Research Provider of the Year - 2018" award by Global Investor, a Euromoney Group company.** To learn more, visit www.marmoremena.com

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In a nutshell ESG are measures used by investors to evaluate the Environmental, Social and Governance aspects of a company. The end goal is to invest in companies or instruments that have relatively less negative impact on the environment and society, are more sustainable and does not have any major governance issues.

Practical issues related to ESG

Although on paper ESG looks like a simple no brainer concept, it poses a great deal of issues.

- Uniformity: At present, there seems to be no standard ESG reporting framework or a standard ranking methodology. Companies choose what they disclose (and what they don't).
- Subjectivity: Since most of the parameters used for assessing the ESG of a company are qualitative than quantitative, putting a number on them is highly subjective. The same company might have a higher ranking as per one institution and come at the bottom lot when ranked by another.

Below is a table of the correlation of ESG ratings by various institutions. MSCI's correlation with both S&P and Sustainalytics is below 50%. This is in sharp contrast to the correlation of long term debt by S&P, Moody's and Fitch for the same 400 firms which comes to 94% and 96%, respectively.

ESG Ratings comparison: Correlations

	MSCI	S&P	Sustainalytics	CDP	ISS	Bloomberg
MSCI	-	35.7%	35.1%	16.3%	33.0%	37.4%
S&P	35.7%	-	64.5%	35.0%	13.9%	74.4%
Sustainalytics	35.1%	64.5%	-	29.3%	21.7%	58.4%
CDP	16.3%	35.0%	29.3%	-	7.0%	44.1%
ISS	33.0%	13.9%	21.7%	7.0%	-	21.3%
Bloomberg	37.4%	74.4%	58.4%	44.1%	21.3%	-

Source: BDO USA, LLP

Additional issues in Emerging Markets (EM) like GCC:

The "S" in ESG:

ESG is not an entirely new concept in the Islamic finance segment, at least with respect to sustainable and socially responsible investing. Islamic finance stands by the goals and objectives of Shariah. Sectors like tobacco, gambling have already been prohibited on religious ethical grounds. Shariah compliant investments naturally overlap with ESG and Socially Responsible Investing (SRI) requirements.

Comparing an emerging market company with that of a developed market company, in terms of ESG, will be an apples to oranges one. Some articles even say that global ESG standards are partial towards EM. The following might be the reasons for the same:

- Cultural differences: Things as simple as having a diverse board as a criteria for ESG ratings might reduce the ranking of a company where entry of women into the workplace is relatively a new concept for the region. Also, in the GCC region, members of the royal families hold powerful positions in the board of many companies. In this regard, The Kingdom of Saudi Arabia has recently passed a new rule prohibiting its ministers from heading boards of companies or being members of the board unless directed by the head of the cabinet.
- Higher degree of family owned companies
- Most of the countries' GDP (within GCC) are heavily dependent on carbon intensive end product's revenue. We have to compare the impact of such products on the environment to the broader socioeconomic impact the absence of such revenue can cause
- Lack of coverage by third party ESG research providers

Hence, the ESG framework needs to be modified in a way that it best suits the unique features of the emerging markets. Following the global methodologies and standards might not reflect a true picture.

In 2020 KPMG surveyed 5,200 companies across geographies and it revealed that North America has the highest regional sustainability reporting rate at 90% of the top companies, as opposed to only 59% in Middle East and Africa[1]. While this represents a sizeable increase from previous years, it is below the average of major regions like the Americas, Europe and Asia Pacific. In October 2020, a top performing EM bond fund avoided investments in Saudi Arabia as it scored low in the fund's ESG ratings[2].

Efforts taken by governments to streamline the ESG frameworks:

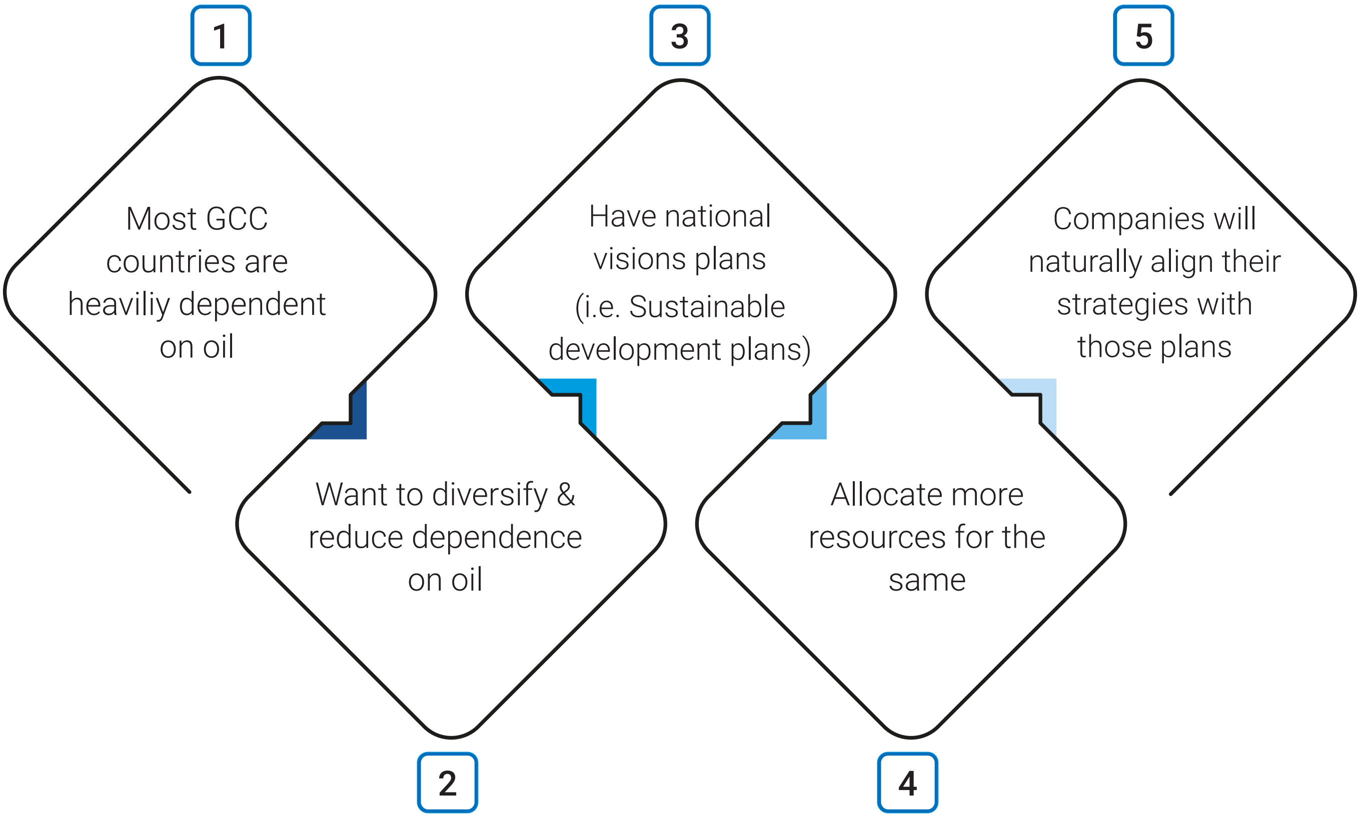
GCC countries are working on their ESG frameworks and taking numerous initiatives in this front in an attempt to expand its funding base by attracting ESG focused investors.

1. Saudi Arabia and Oman have recently announced that they are working on their ESG framework.
2. Qatar Stock Exchange is likely to introduce mandatory ESG disclosure requirements from January 2022 and a sustainability benchmark by October 2021.
3. Companies listed in the United Arab Emirates (UAE) are required to mandatorily publish their sustainability report.
4. Bahrain Bourse has issued voluntary reporting guidance for listed companies.
5. Several sovereign wealth funds, including the Abu Dhabi Investment Authority, the Kuwait Investment Authority, the Qatar Investment Authority and the Public Investment Fund of Saudi Arabia, are signatories to the One Planet SWF Framework, which can raise awareness of the topic for local corporates — especially where these funds have large domestic portfolios with significant ownership of local companies, such as the in case of PIF[3].
6. Boursa Kuwait launched its new ESG guide in September 2021, to raise awareness and drive the embrace of Corporate Sustainability in the Kuwaiti capital market.

[1] *KPMG*
[2] *Bloomberg*
[3] *S&P Global*

Why now?

- **Pre-existing need for diversification:**



1. The Countries in the Gulf have been wanting to minimise their dependency on oil. For example, Saudi Arabia derives around 50% of its GDP from the oil and gas sector.
2. They are looking to diversify and increase revenues from more sustainable sources.
3. KSA, has included issues like poverty, inequality, climate change etc. in its national strategy. It also attempts to gradually move away from investing in instruments and institutions which do not have their own sustainability plans.
4. Saudi Arabia's sovereign wealth fund plans to announce its first issue of green bonds "very soon". The PIF has also been investing and increasing its existing stake in companies that spend more on renewable energy.
5. Hence, the companies in the region (like AWCA Power) are encouraged to comply with ESG and align their vision accordingly. Also, governments are looking to expand their investor base and foreign investors are more focused on ESG.

- The catalyst called COVID: This can be considered as one of the silver linings in the COVID cloud. Uneven vaccination distributions and an increased focus on common good highlighted the need for ESG investing. In the MENA region, COVID had a dual impact on the markets; where both oil & share prices fell, intensifying the need to diversify from oil.

  Also, with the shift in demographics of wealth owners across the globe, millennials and gen-z are more focused on sustainable investing.

- Greenium (Premium paid for green bonds): Although the risks associated with repayment of green bonds is the same as a normal bond issued by an institution, Empirical research suggests that they have a premium. Reasons might be

  vi. Investors are willing to forgo higher returns because of environmental benefits

  vii. Recent increase in demand

  Both issuers and investors saw the advantage in being green, this brought down the cost of borrowing[4].

- Growing Demand: More than $3tn in fiscal stimulus globally will be dedicated to financing a green recovery, while ESG assets may top $53tn by 2025, representing more than a third of projected total assets under management, according to Bloomberg Intelligence's Global ESG 2021 Outlook. Green financing linked to sustainability projects in MENA increased by 38% to $6.4 billion in H1 2021, topping the amount raised through the whole of last year[5]. Also, Saudi Electricity's green sukuk issuance in 2020 was oversubscribed five times.

Hmm, does ESG based investing actually work?

The financial impact of ESG, for companies, is twofold:

i. Lower cost of capital: MSCI has compared the data of 960 emerging market companies from Dec. 31, 2015, through Nov. 29, 2019 to find that the high rated companies have lower cost of capital, since these companies tend to have higher corporate governance standards, it reduces their default risks. Also, this is in line with the "greenium" concept.

ii. Higher returns: Companies with higher governance and sustainability standards proved to be more resilient and performed well in the long run. Lower interest rates, competitive advantage from better management of resources also act as a tailwind.

Both the advantages make valuations more attractive.

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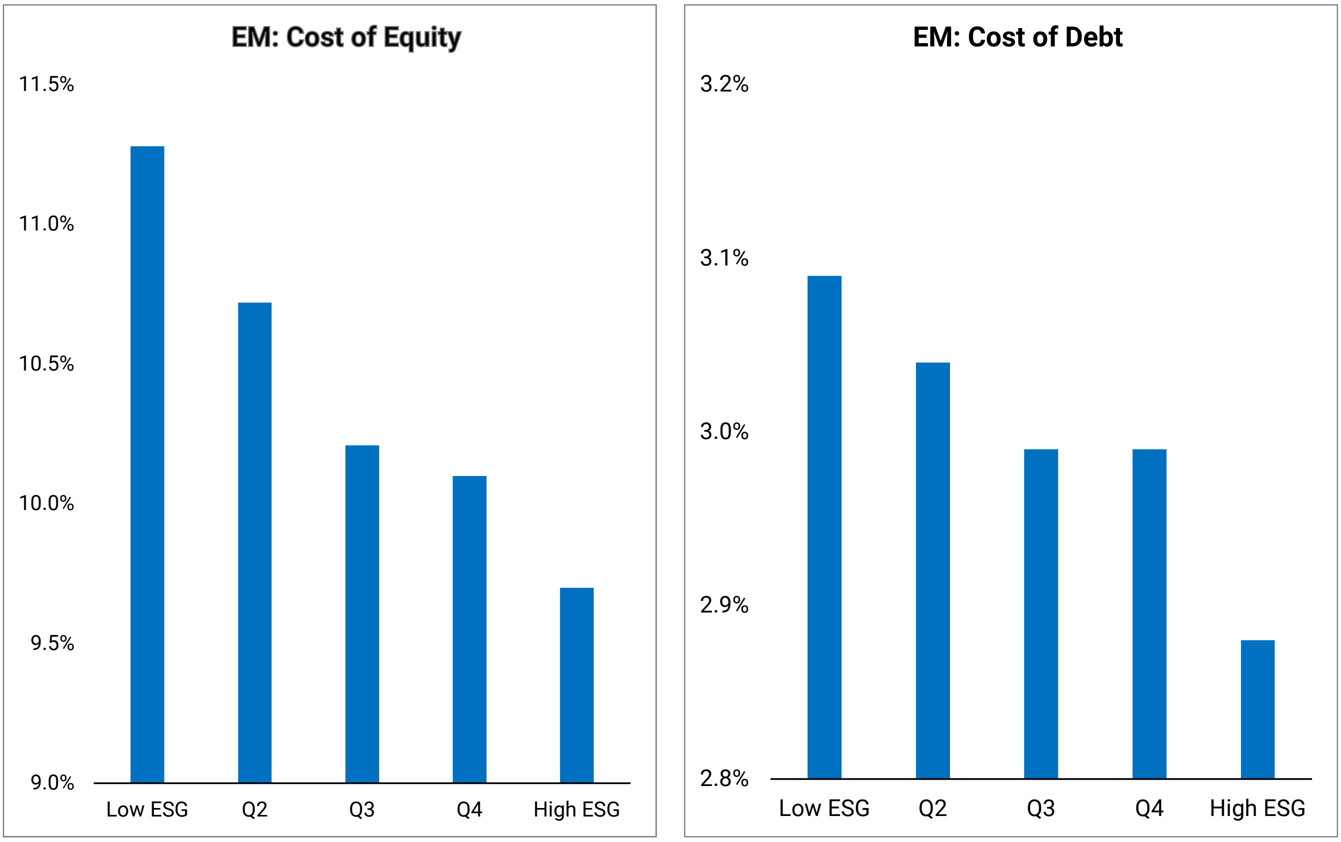
[4] *Capital Monitor*

Figure 1: Comparision of cost of capital of EM companies across different ESG rankings



Source: MSCI ; The Q in these charts represent different groupings done by MSCI for analysis.

[5] *Bloomberg*

Various ESG based Indices:

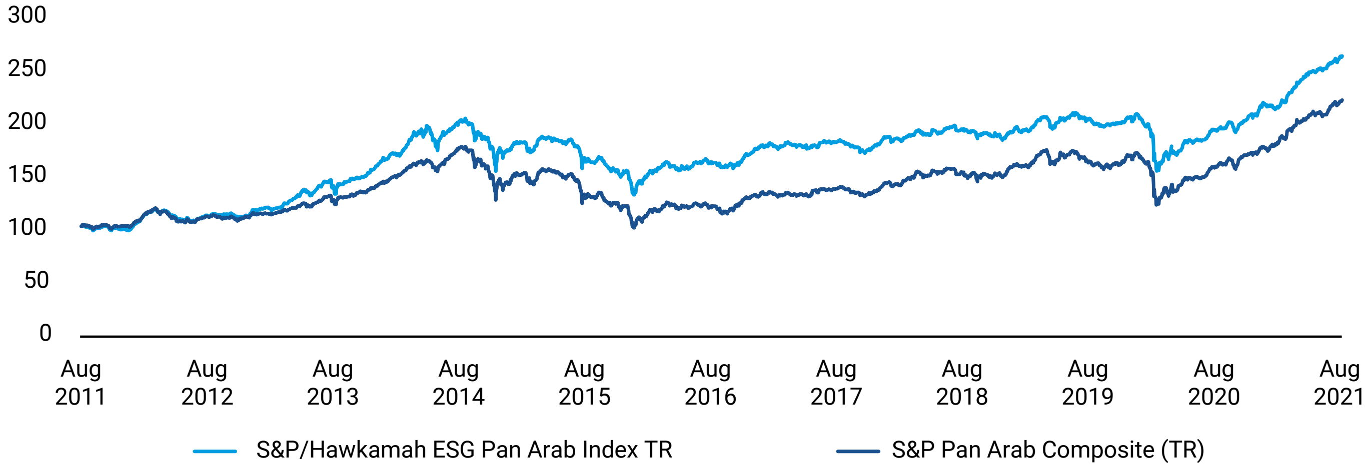
MSCI has developed more than 600 equities and fixed income ESG indices, while S&P Dow Jones Indices has more than 75 indices based on ESG. FTSE Russell also has a number of sustainable investment indices which aim to integrate ESG and investment considerations into single index solutions, sustainable investment data models, ratings and analytics[6].

GCC based indices:

- To cater to investor demand for an ESG index focusing on the Arab region, S&P's and Hawkamah (the Institute for Corporate Governance for the MENA region) have jointly launched the an Index in Jan 2011.
- Saudi has announced plans to launch its own index in cooperation with MSCI.

[6] *Capital Monitor*

Figure 2: Historical performance of the indices



Source: S&P filings; Data has been re-based at 100

Increase in investor demand for ESG compliant instruments, need for GCC countries to diversify from oil, attractive cost of ESG financing & increased costs associated with ignoring ESG are expected to drive companies and institutions to adapt to the new reality. The first step for the governments and stock exchanges would be to come out with a uniform framework for ESG reporting and ranking. Almost all the major countries have announced their plans for the same. Once companies start reporting their data in a structured way, meaningful interpretations can be made by interested investors and could ultimately result in additional capital inflows. Also, increased efforts to spread awareness amongst local investors on ESG could help unlock the full potential benefits of the same.

Authors

M.R. Raghu CFA, FRM, FCMA
Chief Executive Officer
+965 9406 6659
RMandagolathur@e-marmore.com

Samyuktha R
Senior Research Analyst

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