

INFRASTRUCTURE BOOM COULD TRIGGER BOND SURGE

Sovereign and quasi-sovereign bond issuance out of the Middle East has dropped significantly during the last few years but huge infrastructure projects could prompt a great deal more during the next decade. By Jason Mitchell.

In 2022, total issuance out of the Middle East amounted to US$10.78bn, down from US$37.82bn and US$15.37bn in 2020 and 2021, respectively, according to Refinitiv. However, this year, supply started to pick up again – between January and the end of April 2023, it added up to US$15.92bn.

Last year, Saudi Arabia accounted for 50% of issuance, followed by the United Arab Emirates at 28.7% and Israel at 15.7%. Between January and the end of April this year, Saudi made up 61%, Israel 12.5% and Jordan 7.8%. Supply peaked in 2020 during the Covid-19 pandemic when oil and gas prices declined and Middle East sovereigns were forced to seek alternative sources of financing.

Total Islamic bond issuance out of the Middle East is also decreasing — it totalled US$12.11bn last year compared with $26.87bn in 2021, according to Refinitiv. Last year's was a seven-year low. Issuance amounted to US$8.2bn between January and the end of April this year. Sukuk accounted for one-third of the Islamic bond proceeds in 2022. However, green bond issuance is surging in the Middle East – between January and end of April this year, total issuance amounted to US$9.5bn compared with US$4.84bn for the whole of last year and US$3.57bn in 2021. Many countries in the region have started to adopt a green agenda and want to pivot away from oil and gas. For example, Saudi Arabia wants to achieve net zero by the year 2060.

Debt markets in the Gulf Cooperation Council area – the regional grouping made up of Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE – have historically remained relatively smaller in size and underdeveloped compared to other global regions. The average debt-to-GDP ratio for the Middle East and Central Asia region stood at 47.3% in 2022 compared with 85.3% in the European Union and 128.4% in the G7 grouping of economies, according to Marmore MENA Intelligence.

"Though the smaller size offers scope for growth, primary market issues are relatively lower and skewed towards long-term maturities and often promote buy-and-hold strategies, which has resulted in shallow secondary markets, devoid of liquidity," said M R Raghu, chief executive officer of the market research company.

"However, the coronavirus pandemic – coupled with an historic fall in oil prices – resulted in an economic fallout, leading to several Gulf states looking at alternatives to bolster their finances, with 2020 witnessing a slew of sovereign issuances from most of the Middle Eastern countries. The trend continued in 2021 and 2022, with the sovereigns taking advantage of the low-interest rate scenario to tap the bond markets.

"Given the size of the respective economies and the infra spending plans of Saudi Arabia, the trend is likely to continue in the near future. Middle East sovereigns issue a mix of foreign currencies (US dollars and euros) and their respective domestic currencies. Domestic investors are largely banks who have a buy-and-hold strategy. Large-scale spending on infrastructure projects and providing support to the respective domestic economies is the main reason for sovereign issuances."

SAUDI ACTIVE

During the period 2018 to April 2023, Saudi Arabia was the most active sovereign issuer out of the Middle East, accounting for almost 45% of supply, according to Refinitiv. It was followed by Israel (23%), Oman (12%), the UAE (9.1%), Bahrain (7.5%) and Jordan (2.9%).

In October 2022, the Public Investment Fund, Saudi Arabia's US$600bn sovereign wealth fund, made its debut in the international bond market by selling its first 100-year green bond, raising US$3bn in total. Some US$500m of 100-year notes were issued at a yield of 6.7%, while US$1.25bn in five-year bonds were launched at 125bp over Treasuries and US$1.25bn in 10-year paper at 165bp over.

In February this year, the PIF completed its second green bond issuance, which raised US$5.5bn. The latest offering was more than six times subscribed and was issued in three tranches: a US$1.75bn seven-year, a US$2bn 12-year and a US$1.75bn 30-year. The bond was sold to a wide range of institutional investors globally, including Asia.

PIF says it will allocate an amount equal to the net proceeds of the issuances to finance green projects in line with its green finance framework. They include renewable energy, energy efficiency, sustainable water management, pollution prevention and control, green buildings and clean transportation.

The kingdom has an ambitious transformation plan, called Vision 2030, to diversify its economy away from oil by the year 2030. PIF is the main agency implementing the plan, which includes a series of 'giga projects'. The biggest is NEOM, a planned US$500bn high-tech business zone and futuristic smart city located in the desert in Tabuk province. The project includes The Line, a 170-km linear city with an entirely glass mirror exterior that will house up to nine million people.

Saudi Arabia also plans to invest US$148bn in a new airport in Riyadh and to set up a new national airline, Riyadh Air, with 100 flight connections around the world.

"As a result [of all the giga projects], the PIF may require significant financing in the future," said Raghu. "By tapping into the burgeoning green bond market, the PIF can access new liquidity pools at a favourable time."

In January this year, the Saudi Arabia sovereign also sold US$10bn in a three-part bond issue, taking advantage of a window of opportunity to tap debt markets amid strong investor appetite for Gulf credits. The deal comprised a US$3.25bn five-year, a US $3.5bn 10.5-year and a US$3.25bn 30-year.

"Historically, Saudi and the UAE have been the busiest markets in the Middle East across debt issuance – that's bonds and loans," said Iman Abdel Khalek, co-head of Central & Eastern Europe, Middle East and Africa debt capital markets, at Citigroup. "I think this year is no exception. We are seeing a lot of activity out of Saudi, a lot of activity out of the UAE. But also a lot of enquiries from the other jurisdictions. The activity that we have seen this year has been very much focused on sovereigns, banks and quasi-sovereigns. The sukuk market, in particular, has been exceptionally strong, with those transactions faring a lot better in terms of investor demand and oversubscription levels.

"Absolutely, there is a lot of economic activity taking place in Saudi. Vision 2030 involves a lot of capital expenditure and growth in different parts of the economy and that will require funding. Funding will come from domestic sources and from international markets. I would expect a lot more activity. I think there will be more issuance out of Saudi but I do think that there will be a lot of activity in the UAE as well.

"On innovation, we have seen activity in the infra space in the Middle East because of the scale of the infra investments. We have seen project bonds and instruments structured against highly rated, stable cashflows from infra assets. I think there is a lot more to come from this space and a lot more work to be done in terms of creating a bigger pool of investors for this pool of assets than exists today."

Among the seven emirates that make up the UAE, Abu Dhabi and Dubai are the biggest issuers, followed by Sharjah, which also issues bonds occasionally. For instance, in October 2022, Mubadala, Abu Dhabi's US$284bn sovereign wealth fund, sold US$1bn of 10.5-year Formosa bonds through its debt-issuing entity Mamoura, attracting more than US$4.2bn in orders. In February, Sharjah sold its first sustainable bond, a US$1bn long nine-year that drew some US$3bn of demand.

IMPORTANT AND RELEVANT

"The Middle East is very important and very relevant in the context of global growth markets," said Neil Slee, head of emerging markets capital markets at Goldman Sachs. "The Middle East is a key region that is going to be critical for any financing that we are doing; if you're running a business, you're going to say that the Middle East is going to be a significant portion of any future work in a global context.

"I think it's fair to say that we have probably moved past the peak bond environment for the Middle East. It was driven by a period when there were lower oil prices, when the region moved from being a net supplier of money into the market to being a net borrower. That was a big shift. Now, I would say the difference is that issuance is much more specific to individual countries and their own objectives.

"If you look at the region, while everyone has come down from the significant funding that they were requiring a few years ago, certain countries like Saudi Arabia have very ambitious plans. It is dominating issuance while you have seen some other sovereigns, for example Qatar, clearly scale back. Given where the oil and gas prices are, Qatar is in a position where it does not necessarily feel the need to borrow significantly from the market and if anything is reducing the amount of debt it has outstanding."

SUKUK ROLE

For its part, Islamic finance could be poised to play a greater role after a lacklustre year.

"Total global sukuk issuances dropped in 2022 as compared to the previous year, mainly due to the macroeconomic conditions of elevated oil prices, high inflation, and rising interest rates, which in turn led to reduced global demand for emerging markets debt and lower financing needs from some main Islamic finance markets (predominantly oil-exporting countries)," said Ahsan Ali, head of Islamic origination, corporate, commercial and institutional banking and Islamic Saadiq Banking at Standard Chartered.

"The Middle East is a key region that is going to be critical for any financing that we are doing; if you're running a business, you're going to say that the Middle East is going to be a significant portion of any future work in a global context"

"For 2023, we believe that global sukuk issuances will increase compared to 2022 despite volatile market conditions and high funding costs. The reasons are threefold: first, an increased liquidity pool with Islamic investors, particularly in the GCC, will drive issuers toward sukuk and further increase the share of sukuks as compared to conventional bonds in the core Islamic finance markets; second, while continued high oil prices may reduce the funding needs of oil-exporting sovereigns, on the flip side, we may see increased issuances from oil-importing nations; and, third, vast infrastructure spending in countries like Saudi Arabia may spur issuances from corporate and government-linked entities which will introduce a new source of sukuk supply."

An important trend in international sukuk issuance last year was an increase in the number of green and sustainable offerings. For example, in February 2022, Riyad Bank issued a US$750m Additional Tier 1 sustainability sukuk, which was the first global AT1 sustainability sukuk and the first emerging markets AT1 in a sustainable format.

"We think this bodes well for the development of the green/sustainable/social sukuk issuance, as there are a number of sovereigns, sovereign-linked entities, banks and corporates in the process of developing their ESG frameworks and waiting to access this market," said Ali.

Demand for sukuk remains strong and comes from a combination of Islamic banks and institutional investors in the GCC, including sovereign wealth funds, asset management companies, pension funds and family offices. In addition, there is increased appetite from conventional investors in Europe, Asia and the US. Private banking and high-net-worth investors also constitute a large investor pool, particularly for higher-yielding instruments; however, their investment is typically channelled through banks or portfolio managers.

"Multilaterals and governments are usually the first issuers to introduce sukuks in any country," said Ali, "and this is critical to support sukuk market development to provide confidence to stakeholders and educate them on sukuks and pave the way for other issuers (corporates and financial institutions) to tap the sukuk markets. For new markets, it is critical for the government to tap the market first to encourage other issuers to follow their path, as well as provide a pricing benchmark to the investors."

"A sovereign will issue a conventional Eurobond or a sukuk Eurobond depending on the sort of investor they want to attract," said Citigroup's Khalek.

"Sukuks are a tool to diversify the investor base because the pure sharia-compliant investors – which are predominantly banks in the region – cannot buy conventional Eurobonds, so to tap into this liquidity you have to structure something that is sharia-compliant. In itself, that will attract this pool of capital but will also attract the regular buyers who would have otherwise bought the conventional Eurobonds. It is a more inclusive way of tapping the market. For example, the typical distribution chart for a sukuk would involve, roughly, 40%–50% Middle Eastern investors, 20% US, 10% Asia and 20% Europe. The 40%–50% Middle East is a combination of conventional and pure-play Islamic institutions."

GROWING SOPHISTICATION

Bankers feel that the GCC's capital markets are becoming more sophisticated and will be one of the world's major growth markets in the future. For example, Saudi Arabia's economy expanded by 8.7% last year, one of the fastest rates globally. Under its Vision 2030 plan, the economy is expected to grow by 6.5%–7% a year.

"In the GCC, we went through this period where there was supply only from a few specific names – a few quasi-sovereign-type investment funds – to suddenly this period when all the big sovereigns were borrowing on a large scale and in an almost consistently identical pattern," said Slee. "But it has now moved to a point now where this is a mature market and it is very much driven by individual perspective needs, funding requirements.

"Across the debt market, the equity market, the bonds, the loans, structured trades, the GCC is definitely a market which has a huge amount of opportunity and a huge amount of investment potential. How exactly some of this will be funded is up for debate. If you're a financial institution and you're looking at a region where you think there are a lot of interesting opportunities, absolutely the Middle East is there. We have been growing our presence with our Dubai office and expanding into other parts of the region, building our Saudi office and our Qatar office. I see the region as super-exciting and super-interesting."

"The outlook for Middle East bond issuance depends on two major factors," said Raghu at Marmore MENA Intelligence: "the oil price outlook and US Fed rate. If oil prices remain stable at the US$70–US$85 per barrel range, it is a comfortable level for most of the oil-producing nations. Oil may be vulnerable to slowing demand but the Organisation of the Petroleum Exporting Countries, through its production cuts, should manage to keep oil prices above US$70 per barrel, a supportive level for GCC sovereign credit profiles. With the US Fed expected to increase rates by a further 100bp by the end of the year, some of the Middle East sovereigns could use the current rates to raise debt rather than wait for the rates to rise."

The Middle East's debt market has come off the boil from the 2020–21 period, as oil and gas prices have shot up and the region's sovereigns and quasi-sovereigns are now awash with liquidity. They do not feel the need to raise capital, particularly in a period of high global interest rates. However, some countries in the region – in particular Saudi Arabia – have massive infrastructure spending plans that could lead them to tap the bond markets on a large scale in the future. They could also turn to the debt market to finance many planned green projects. ■