

# UNDP MALDIVES - ECONOMIC BULLETIN

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## The case for de-risking investments to attract private capital for underserved sectors in the Maldives

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The Maldives is one of the top five Small Island Developing States (SIDS) host economies for Foreign Direct Investment (FDI). It has attracted millions of dollars in FDI each year, with records showing an average net inflow of FDI representing 11% of national Gross Domestic Product (GDP) between 2013 and 2020. In fact, this inflow is considerably higher than many peer jurisdictions such as Fiji (7%), Mauritius (3%), Sri Lanka (1%) and the Seychelles (10%) for the same period.[1]

However, in the wake of COVID-19, FDI fell by 63% in 2020.[2] This was not surprising, as much of the FDI is concentrated in tourism and related services, which took a big hit. While the Maldives' economy, tourism and FDI has seen signs of recovery, there were further shocks emanating from the crisis in Ukraine i.e. a significant rise in food and fuel prices, a reduction in Russian and Ukrainian tourists and a higher current account deficit, and the quantitative tightening underway in the US and Europe. This is likely to make FDI flows and greenfield investments more uncertain and refinancing of debt more costly.

Going forward, the focus needs to be not just on

reviving FDI inflows but on diversification of the focus areas to link better with the sustainable development priorities of the Maldives (e.g., blue/ocean economy, agriculture-fisheries, renewable energy and other domestic economy facing sectors) and, in line with this, a diversification of investor base, with a focus on attracting impact investors and sustainable capital to address these development priorities and complement more conventional types of FDI. As the Maldives has limited mechanisms in place nationally to capture granular data for private capital, UNDP analysed a sample of 58 FDI transactions worth nearly US\$2 billion from the Maldives spanning between 1995 and 2021 recorded by S&P Capital IQ, a market intelligence platform which specializes in tracking FDI deals[3] around the world.

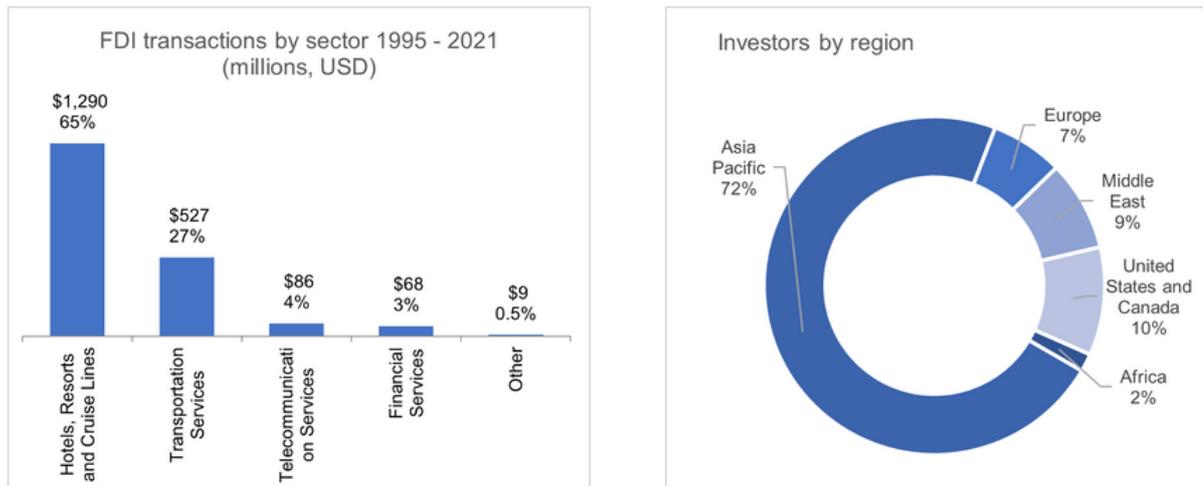
The data presented below (Figure 1) paints a picture of investor preferences heavily skewed towards a handful of sectors with close linkages to the tourism sector, which is unsurprising for the Maldives given that it is a high-end tourist destination. The data shows that investors strongly prefer financing tourism, with 65% of all deals (\$1.3 billion) representing acquisitions and mergers of hotels, resorts, and similar

[1] World Development Indicators (WDI): UNCCD Knowledge Hub for 2020 figures, also see World Bank WDI database <https://data.worldbank.org>

[2] See UNCTAD World Investment Report. FDI was estimated to be \$956 million, \$348 million and \$443 million in 2019, 2020 and 2021 respectively.

[3] The data from S&P Capital presented in Figure 1, is not an exhaustive list of Maldives FDI Inflows. This data represents only a sample of FDI inflows into the country and actual FDI inflows into the Maldives are likely to be higher.

Figure 1: Maldives FDI trends and investor diversity



Source: S&P Capital IQ

assets, while the transportation services sector represents 27% of transactions (\$0.5 billion), primarily capturing the ownership sale of airlines, airports, and marine transport solutions. Transactions in telecommunications and financial services sector represent a handful of intermittent deals including local Initial Public Offerings (IPOs) that took place between the sampling period and are not a regular occurrence. Other transactions which represent only 0.5% of deals mostly came from underserved sectors such as Information and Communications Technology (ICT) services, utilities, food processing, light manufacturing and entertainment sectors, often as one-time transactions indicating challenges the country faces in attracting investments on an ongoing basis.

Investors appear to target sectors with potential for economies of scale with the opportunity to serve the increasing number of mostly well-to-do foreign tourists (in addition to resident population) while earning in foreign exchange to mitigate their risks. Many of these investments also have limited linkages to the local economy. The data in fact shows that investments in more domestic-facing sectors represent less than 4% of the deals. Industries such as agriculture, fisheries, health, and essential utilities, which face typical supply-side issues and challenges in achieving

economies of scale, have extremely limited traction in attracting FDI towards a range of areas related to blue and ocean economy. Such factors, however, are critical to sustaining both the tourist-facing and the domestic economy.

In terms of profile of investors, an analysis of Maldives' investor base shows that deals have primarily originated within the Asia Pacific region with 72% of all transactions recorded coming from the region, while other investors represent 10% and fewer deals. An analysis of the composition of investors from the region shows that 54% of the investors are based in just four countries (Singapore, Japan, Thailand, and Sri Lanka), further demonstrating the lack of diversity of the investor base. This represents a rather limited success for Maldives in attracting investments from other regions. Catalysing global investors outside Asia Pacific should be an important strategy in future policies and plans for investment expansion.

The prospect of climate change significantly increases the complexity of the aforementioned challenges by altering, amongst other factors, the risk-return calculus which has governed global investment regimes for decades. The Maldives will certainly need to maintain a steady flow of tourism investments. However, whether the country will continue to remain an

attractive destination for such investments is increasingly becoming an issue in view of the need and costs of adapting tourism infrastructure to climate change. The frequency and intensity of extreme weather events such as wave swells and severe flooding are constantly threatening tourism infrastructure. While at the same time rising temperatures are causing coral bleaching, further degrading a major selling point for the tourism industry.

A UNDP supported study[4] conducted in 2015, which looked at the impact of climate change on the Maldivian tourism industry, predicted that the country could experience a loss of tourism revenues equivalent to 8.6% - 10.4% due to climate change by 2020, rising to 14.4% to 18.2% by 2050. Existing tourism development models in Maldives will need to undergo a review as tourism investments need to come to terms with the increasing cost of operating facilities in the Maldives arising from disaster risk reduction to climate change and climate adaptation. The country will need to develop a stronger narrative for preserving its premium status as a global destination for tourism investments and more importantly, to attract capital for its domestic-facing industries outside the tourism sector.

Similar to many SIDS, Maldives faces non-climate issues in attracting private capital: the problem of scale economies, challenges in profit repatriation stemming from currency convertibility issues and crowding out of private investments from the presence of public sector in what would otherwise be private investment driven markets. The country also faces a range of macroeconomic challenges, including limited fiscal space and rising debt levels. Budgetary data for 2022 suggests that nearly 67% of the state budget is expended on recurrent expenditure (with 44% of the budget spent on public sector salaries,

subsidies, and welfare programmes with limited opportunity to drive capital investments and public services. Debt stood at 113% of GDP by Q1-2022, with debt repayment estimated to rise to \$600 million in 2026 on account of the bullet payments on the sukuk and a privately placed bond[5]. The Maldives will need a private sector-driven investment programme and solid revenue expansion measures to unlock fiscal space and to attract investments for its domestic-facing industries well beyond tourism.

Much more needs to be done to support the country unlock fiscal space to address the emerging macroeconomic vulnerabilities. Given the Maldives' income status as an upper middle-income country, the country is less likely to attract foreign grant funding in the future, as traditional donors reallocate capital from graduating economies to least developed countries or in crisis contexts. A pathway to reduce reliance on pure grant modalities for project financing is needed, while creating capacities and governance mechanisms geared to tap innovative financing solutions. This will require rethinking the current financing practices and greater vertical and horizontal coordination between public and private sector, Development Finance Institutions (DFIs) and donor agencies.

Here it is important to engage impact investors and consider measures to crowd-in and attract investments for some of its domestic-facing industries, such as energy or to incorporate a focus on underserved populations or sectors which are perceived to present a higher risk. There is a growing interest in this regard in approaches to 'blend' impact focused capital i.e., capital whose primary objective is positive impact rather than a sole focus on financial performance with private institutional capital to help mobilize private capital into transactions by de-risking or otherwise enhancing the attractiveness of the

[4] UNDP Maldives and Ministry of Tourism (2015): Economic costs and benefits of climate change impacts and adaptation to the Maldives Tourism Industry, Tourism Adaptation Project (TAP)

[5] Finance Minister's remarks in Maldives Parliament's Economic Committee session on 26 May 2022

investments.[6]

In particular, a fast-emerging model which underpins many blended financing solutions, which can be relevant to the Maldives, is a measure called the “first-loss capital” solution to catalyse private investments. In its most basic form, it is a guarantee to absorb initial losses from a private investment – usually provided by cause-driven agencies such as philanthropic foundations, governments, and DFIs – with a higher risk appetite or commitment. Such guarantees are normally provided for projects with strong social and/or environmental returns but where financial returns are determined to be not feasible due a variety of reasons. A guarantee of this nature, which promises to take away the first losses in commercial transactions, can significantly improve a transaction’s financial profile, attracting investors (such as banks, institutional investors) who will not otherwise invest in such projects.

*Implementation of de-risking mechanisms do not guarantee future investments and should only be seen as an important starting point for attracting investment for SIDS such as the Maldives.[7] Building investor confidence is a gradual and delicate process and the consideration of de-risking and other mechanisms should be complemented by the implementation of sound macroeconomic management policies to demonstrate the commitment to reforms and to ensure investments flow in a sustainable and predictable manner.*

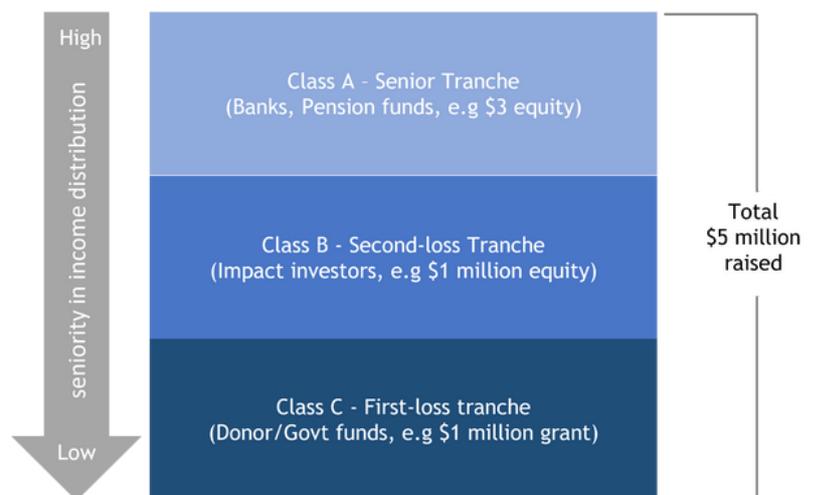
One of the most prominent examples of a large scale, first-loss catalytic blended financing mechanism is the UN’s Global Fund for Coral Reefs (GFCR), which is the first vehicle of its nature dedicated for SDG 14, ‘Life Below Water’. The Fund is building a resilience-focused portfolio of blended finance solutions backed by public and private investments. With a pipeline currently spanning 25 countries, it delivers finance to support reefs with the best chance of surviving climate change, GFCR deploys grants (through a UN-managed Grant Fund) to establish financial tools and incubate reef-positive businesses ready for scaling and duplication through private investment. In 2021,

**Figure 2: Capital Structure of a typical first-loss catalytic transaction**

The highest risk tranche is the first loss tranche (Class C) that will absorb the initial losses. The funds for this tranche can come from donors and government with high-risk appetite.

This limits the losses for other investors in Class A and B (Banks, Impact Investors), thereby enhancing their investment security and improving the overall financial profile of their investment.

Financially, the \$1 million first-stop tranche catalyses an additional \$4 million – resulting in an overall investment of \$5 million.



Source: UNDP, author illustration

[6] See, ITF Taskforce “Mobilizing Institutional Capital towards the SDGs and a Just Transition; World Bank (2022) De-risking Investments to Build a Green Maldives and UN/DESA Policy Brief #100: Effective blended finance in the era of COVID-19 recovery (12 April 2021).

[7] See UN/DESA Policy Brief #100: Effective blended finance in the era of COVID-19 recovery (12 April 2021) which offers useful guidance and caveats, including underscoring that, “analysis should always include measurement of the cost of blending versus other financing mechanisms. For example, the biggest infrastructure needs may be in social infrastructure or other areas that might not be profitable to private investors, even with enhancements.”

the Green Climate Fund (GCF) approved[8] a commitment to a first-loss tranche of up to \$125 million to catalyse GFCR's Equity Fund - to essentially encourage other commercial investors to invest with the Fund. The GCF Accredited Agency is Pegasus Capital Advisors Inc. as manager of the Equity Fund. Deals made through the Equity Fund will be mostly FDIs for recipient countries, largely governed by the FDI laws in those countries while, the Grant Fund will support the public and private sectors to incubate a pipeline of investible projects. Taken together, the GFCR Grant and Equity Funds provide an innovative blended finance solution to de-risk investments in the blue economy.

The Maldives is a priority country for GFCR[9] and can provide a rare opportunity to de-risk and attract foreign investments towards priority areas such as fisheries and sustainable waste management and recovery where FDI inflows have been remarkably low as discussed earlier. This is also a strategic opportunity for the country to diversify its investor base and send a strong signal to the global investment community that the Maldives is an emerging market for impact-driven foreign capital.

First-stop loss mechanisms have also been used at smaller scales, for socially driven endeavours. According to Global Impacting Investment Network (GIIN)[10], In 2012, the Government of the Netherlands provided a catalytic first-loss capital grant of \$1.2 million to a Fund Manager in Tanzania (Equity for Tanzania Ltd) to direct impact investments resulting in reduction of poverty by empowering entrepreneurship opportunities in the country. In this case, the Fund manager reported that the mechanism was able to

catalyse an additional \$3.6 million from multiple investors. For a different transaction in Australia in 2022, the Government provided \$4.1 million in first-stop loss capital to a local not-for-profit fund to ease access to finance for low-income Australians, resulting in additional capital of \$5.5 million for the non-profit fund. UNDP analysis[11] has shown that the Maldives operates a range of grant making public trusts (such as green fund, zakat fund) and grant capital from such trusts are ideal for capitalising first-loss capital deals, making such investment structures particularly attractive for the Maldives. An obvious advantage of this mechanism is the use of grant capital to mobilise additional private capital and bringing in an element of financial discipline into project financing, that is not possible in purely grant financed projects.

In the Maldives, the UNDP is engaged in several projects to support private sector facing investments in the country, with a broader scope of creating fiscal space for the government. A climate investment mapping exercise has also been launched in partnership with Invest Maldives[12], the country's investment promotion agency, to provide economic intelligence particularly in prioritized sectors which span renewable resources and alternative energy, services (tourism), food and beverage (agriculture), waste management, infrastructure, healthcare, and education and move to discovery of a pipeline of high-impact climate investment opportunities in the country and present the case for foreign investors and broaden the country's current investor base. UNDP is also working with the insurance regulator to conduct a diagnostic of Maldives insurance markets to identify ways to mainstream innovative risk transfer solutions in the country, to reduce public expenditure on

[8] GCF news update (November 2021): <https://www.greenclimate.fund/news/global-fund-coral-reefs-brings-together-grant-and-investment-windows-gcf-cop26-event>

[9] In March 2021, the Global Fund for Coral Reefs (GFCR) approves first round of programming, including four preparatory grants to develop full programme proposals to be considered at the next GFCR Executive Board meetings. In the case of the Maldives, the GFCR will be working with UNDP to "demonstrate the blended finance platform to catalyse private sector investments"

[10] GIIN Issue brief Catalytic first-loss capital (Oct 2013)

[11] UNDP Maldives Bulletin 3 (2021) reported that between 2015-2021, the Green Climate Fund collected an average revenue of \$38 million per annum, collecting a total of \$266 million during the period.

[12] See SDG investment mapping mission: exploring SDG-aligned investment opportunities in the Maldives

unpredictable disaster risk reduction and mitigation measures and also to engage the insurance industry as investors. Additionally, an Integrated National Financing Framework (INFF) is being rolled out in the country, which specifically looks at the climate financing architecture and financing modalities in the country to identify improvements to ease domestic financing for climate action.

The Maldives is already a priority country for initiatives using some global de-risking instruments and it can be a top destination for cause-driven capital if national processes and incentives can be better aligned to tap such capital. Private capital is needed more than ever to address the macroeconomic challenges the country faces and achieve economic diversification outside the tourism sector. This latter aspiration has been there for quite some time, not always achieved in practice. UNDP remains committed in its new Country Programme offer to provide technical assistance and advisory support to the Maldives in this important, and much needed transition.

“With the quarterly Economic Bulletin, UNDP in Maldives intends to revamp its support to SDG Integration to ensure faster progress on sustainable development and offer narrative options in areas such as integrated policy and programming solutions; SDG metrics; and data and analysis using tools for modelling and forecasting.

We aim at promoting the sharing of knowledge as well as innovation, and solicit a more robust pace towards SDG Financing so to expand public and private contributions to reach the 2030 Agenda.”

– Enrico Gaveglia, UNDP Resident Representative in the Maldives.

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