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Where next for business in the Middle East?

The competitive landscape is shifting across the region as consumer tastes change, new digital champions emerge, and governments deregulate.

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In this episode of the *McKinsey Podcast*, Simon London speaks with McKinsey partner Abdellah Iftahy and senior partner Ahmed Youssef about the future of business in the Middle East.

Simon London: Hello, and welcome to this episode of the *McKinsey Podcast*, with me, Simon London. With geopolitics and conflict dominating the headlines, it is easy to forget that the Middle East is home to hundreds of millions of people who are, for the most part, going to work, going to school, raising families, shopping, and so on. This is not to deny the political complexity, but it does call on us to try and understand the Middle East from economic and business perspectives.

For example, can the region create enough jobs to employ its young people? Can governments transition their economies away from dependence on oil and state-owned enterprises? How will the big family-owned groups that have dominated the private sector compete against a new generation of entrepreneurial, tech-savvy competitors?

To discuss these issues and more, I met up in Dubai with Ahmed Youssef and Abdellah Iftahy, two McKinsey partners who work with companies across this very big, very complex region. Ahmed and Abdellah, welcome to the podcast.

Ahmed Youssef: Happy to be here.

Abdellah Iftahy: Thank you. Thank you, Simon.

Simon London: Looking in from outside, the region, I think, has been through a bit of a rough patch. We've had oil prices considerably below where they were. We've also had a fair bit of instability around the region. Ahmed, what's the mood today?

Ahmed Youssef: I think if you ask people that question, you will not get one answer, because it really depends on the leap of faith that you're ready to take or the kind of skepticism that you have. On the one hand, you have people that actually are very bullish about the region because they see the ambitious transformation. They see some of the bold moves. They see some of the big investments. They see a young population that is thriving and wanting to make a difference. They see a market that actually could be attractive and that is very big.

There are others who will basically say, "Well, let's wait and see," because they're skeptical about the geopolitical situation. They're skeptical about the success of the transformation. They're skeptical about this kind of volatility of economic activity, which is also driven a lot by oil prices over the last few years.

Simon London: So glass half empty, or glass half full.

Ahmed Youssef: Exactly.

Abdellah Iftahy: Just to add to that, I think there are some structural challenges that we see today, as well as some big opportunities. I think, on the challenges side, there is an unemployment rate that is very high—I think four times the global average—as well as this youth bulge, which you can see as a big challenge or as a big opportunity.

Today, when you see the youth and the opportunities they have, I think they are quite limited. One out of four kids has the opportunity to go to school and then gets an opportunity for a job later on, which is a challenge. That is also a big reason for hope going forward because if we find solutions for these youth to be employed, to be educated, these will be the drivers of the economy going forward, from a consumption standpoint, from an innovation standpoint, and from an entrepreneurship standpoint.

Simon London: Let's do a little bit of defining. When we talk about the Middle East, when we talk about the region, what are we talking about? How big is it in terms of population and GDP and those kinds of things?

Ahmed Youssef: I mean, "the Middle East" is used with different definitions. I think some use it for GCC [Gulf Cooperation Council], which is six countries: UAE [United Arab Emirates], Saudi, Oman, Kuwait, Qatar, and Bahrain. Some others tag MENA—the Middle East and North Africa.

In our definition, we take the Middle East and North Africa, and we add Pakistan and Turkey as well because of the strong ties that they have to the region. Then if we take that definition, we are talking about a population of 700 million, which is roughly 10 percent of the global population and $4 trillion of GDP.

Ahmed Youssef: For me, the interesting part about the region is the complexity that it has. It has some of the world's oldest civilizations—be it Egypt or Mesopotamia, established around 3000 BCE—and some of the youngest countries. The majority of the countries were created in the middle part of the 20th century, from Turkey to Lebanon to all the Gulf countries. I mean, the UAE, where we are today, was born in 1971.

Simon London: So this contrast between incredibly old civilizations …

Ahmed Youssef: Traditions and youth.

Simon London: … and, actually, quite new institutional structures.

Ahmed Youssef: That's why you see bold, risky moves and traditional, conservative, slow moves. You always see that tension. That also points to the diversity of some of the countries that we actually have.

You have some of the richest countries. If you take the GDP per capita of the richest country and the GDP per capita of the poorest country, it's almost 100 times. If you think about the US, if you look at the richest state to the poorest state, it's around five to seven times. If you look at Europe, all of Europe, not the European Union, it's around 15 times. We have a gap of 100 times. So that gives you a big sense.

You also look at population. You have the population at 200 million in Pakistan and at 90 million-plus in Egypt. You have Bahrain at 1.5 million.

You see, the contrast between the different countries actually is quite stark. That's what makes this region very complex. People talk about the Middle East as one setup, and it's not.

Simon London: If I'm a CEO looking at the Middle East and thinking about "What's my Middle East strategy?" is that a concept that even makes sense? Or have I just got to get very granular about "I need different country strategies"?

Abdellah Iftahy: There is a typical mistake of thinking about the Middle East as one. I think Ahmed has shared some of the contrast that we see here. It is very important for any CEO or any international organization to think about this region in a much more granular way. Country by country, city by city. If I think about Pakistan, every region is very different. If I think about Saudi, the same thing. The regional differences are quite big. Thinking about this region in a granular way is the number-one step for any strategy that should be set here in the region.

In addition, I think local knowledge is extremely important. Because of this diversity, it's not about just sending the top talent from these international companies to the region. It's actually about being here, partnering with local partners, family-owned businesses, or other institutions to really go deep into the culture—the behavior, the consumers, the way of doing business—in each of the different regions or countries and make it successful. Then tailor any value proposition or offering that any company would have to those granular pockets of value.

Simon London: It sounds to me as if you're pointing out some kind of "failure modes" when you look at companies that come from outside the region and don't quite get it right. Would you agree with that, Ahmed? Elaborate a little bit: Where do companies go wrong?

Ahmed Youssef: I would agree with that, but let me give a bit of historical view. Over time, a lot of international companies came in. They had only sales kinds of operations, which means that everything was produced outside. Everything was developed outside. Technology companies, their R&D was in the US, in Germany, in South Korea, or other places. Manufacturing, same thing. Cars were done outside. Consumer goods, food, products, same thing.

Now the success factors have changed. The consumers are much more demanding. They are requiring something that is much more tailored to them. You have local competition that is starting to produce, be it industrial products, food products, and so on. That requires international companies to be closer and closer to this market. Getting closer to this market, for you to be successful, you have to know the market. You cannot just apply what you've done in other markets and come here.

They come in with a lot of misconceptions. The first misconception is, "I come in, I'm going to bring all the capabilities. You provide me the land and local connections and local banking." That's the first thing I urge international companies to think about, is to be humble about what they know and what they don't know and to respect the knowledge of the local players here. That would require them choosing and spending and investing time to understand who the local players are that they need to partner with.

Simon London: Hubris is a failure mode, by the sound of it.

Abdellah Iftahy: Just to add one example to what you just mentioned, Ahmed, I think this holds true for any industry—traditional industries, manufacturing, or even new businesses. Take the example of Uber [Uber Technologies] and Careem—Careem is the local ridesharing company that was very successful that was just acquired by Uber.

I was watching an interview of the CEO of Careem, who was talking about the distinctive competitive advantages they had here versus Uber. He mentioned two things. One is that the Uber model, in the US, for example, was mainly reliant on Google Maps to map the locations and the addresses in the country. The second: it was purely, 100 percent credit-card based.

When you come here, in the region, and you understand that Google Maps is not that accurate, then you have to build that network from scratch. That's what Careem did. They had cars going around and picking up GPS coordinates for every single location of some of these remote areas.

Plus, there is cash on delivery. If you go to Saudi, specifically, cash on delivery is the mode of payment. It's not credit cards. Hence, developing all of these processes around that was required. That gave Careem a big advantage; hence, Uber acquired them.

That's a very concrete example of how replicating what worked elsewhere and bringing the technology and the idea and the concept to the local market won't work, specifically in the Middle East.

Simon London: Does that apply to understanding the consumers in the region as well? Is there a distinctiveness in consumer taste and so on? What do we know about that?

Abdellah Iftahy: The consumers in this region are very diverse, as are the different countries. I think, in our research that we at McKinsey run here, in the region, we have seen some common trends, as well.

Across the region, we see a consumer-behavior and -sentiment conversion to more of that of the average global consumer, in a sense that the consumers are becoming more and more price conscious. Ahmed mentioned there's a lot of spending power in some of these countries. But even in these countries, now we see consumers looking for prices, looking for deals, and so on and so forth.

Consumers are also becoming less and less brand loyal. Today, they are really looking for innovations, new brands, and even cheaper brands. Sometimes, when they switch to these brands, they like the opportunity and stay there. We have seen the number of people that switch to a less-pricey brand double over the last few years.

I think those are the trends that we have seen globally. Now we see more and more of these here, in the region. In addition, I think there is a key driver, which is e-commerce. People are looking for more and more convenience. Five years ago, only 5 percent to 10 percent of people were willing to buy their goods online. Today, that number has gone up to 30 percent, 40 percent, which is quite significant. That's a big driver of e-commerce in the region, where we see all of these deals: Souq [Souq Sellers], Noon, and others that are growing.

Also, I think there is another trend that is important to keep in mind. People are becoming more and more health conscious. That is driven by the government. I think this region is known for some of the highest obesity rates, for example. Hence, the introduction of excise tax. That will have an impact on how the consumers are behaving, going forward, but also on how retailers and consumer companies should adjust locally in order to win in this market.

Simon London: Something else I read in the research, I think, is consumers are increasingly concerned with supporting local businesses. They're looking for local brands. They're looking for local producers, as well, which again—you know, coming from California, which happens to be where I'm based—sounds very familiar. All of this actually sounds very familiar.

Abdellah Iftahy: Yes, absolutely. On that specific point, I think people are becoming more eco-conscious, as well. That's why they are supporting more local brands and so on, especially millennials. Because for them, I think, the ecosystem and sustainability are very high on their values of scale.

I think we see convergence to the global average consumer. I would give some corrections about some misconceptions about the consumer here, in the region: that they are wealthier, that they only buy known brands …

Simon London: They're not price sensitive.

Abdellah Iftahy: … not price sensitive, and so on. I think, now, all the retailers and consumer companies are operating in more-established markets.

Ahmed Youssef: I think there is a maturing kind of consumer taste. If I look at the consumers, they were almost somewhat insecure or trapped with the view that whatever comes from the West is great, so they would just take anything, be it in food, in clothing, in cars, in whatever there is. If you look over the last few years, they're now much more exposed because they're all technologically savvy. They're exposed to the world in a much bigger way than they used to be before.

They're becoming more demanding, and they have pride about the tradition. Although they want to change and see change, they're also becoming more proud of the traditions, more proud of the countries they're from. Therefore, they're demanding much more specialization. They're demanding much more from consumer companies. If I just look at basic F&B concepts, Kuwait is one of the most-interesting markets where you have a number of F&B concepts that were created very locally.

Simon London: I don't know what F&B concepts are.

Ahmed Youssef: Food and beverage—basically, the McDonald's or Burger King equivalent or so on, the concepts that are being created in the region. People are proud that this is something that is coming from the region. It's something that is tailored to them. It's not just something that comes in and they inherit.

Because of that pride, because of the exposure and really kind of understanding their own taste—and that's part of a maturing consumer, right—that, for me, is an example of how there is pride now with the concepts that are being created within the region. It's a bit conceptual, but it's something that we urge international companies not to ignore and not to undermine: the local innovation that is happening. My advice to them is to research these local innovations and understand these local companies because they might be your best entry.

Simon London: Now, something you mentioned a few minutes ago was the scale of the transformation that's going on in the Middle East. Just double-click on that. What are we talking about? Private sector? Public sector? Both?

Ahmed Youssef: The scale of this transformation is, for me, unprecedented in the region. It's in both the private and the public sector. A lot of these challenges have been festering for a while, so it's not like there's a new challenge.

We've always had a younger population growing very fast. I think, with the scale of the population now, the visibility of the region to the rest of the world, there is no option to kind of do incremental steps. A lot of the revenues are coming from the Gulf countries from oil, and that oil is being invested in the neighboring countries. That's predictable and stable and growing at a certain speed—or a bit oscillating up and down.

But your expenses are growing much faster because, traditionally, most of the investment is driven by the government. I think, in the Gulf and some of the countries, 80-plus percent of the investment that is happening is driven by government or government-related entities.

Simon London: Yes. This is state capitalism.

Ahmed Youssef: By default, when this growth is actually slow, and your expenses, which is employment, are actually growing much faster—and, in some countries, you're providing housing, you're providing some subsidies for local employment, you're providing other subsidies—it's creating a challenge that will bankrupt countries, if there's not a step change. That's why we're seeing these bold moves. You have that in the public sector.

In the private sector, you also have a big transformation because a lot of the economy is dominated by family groups. "Dominated" is the wrong word, but they're led by family groups, very similar to what used to happen in the US in the early part of the 20th century, with a lot of the industrialists that were there. They are the ones that were risking their capital and investing in building industries—banking, retail, real estate. A lot of these families today are 50, 60 years old and—this is the difficult part—at the same time, going through a generation transition, which we know doesn't always work. I think after the third generation, the probability of survival is around 15 percent, so a lot of these businesses will not exist or are at threat of not existing. It's about beating the odds for them. They have to go through a big transformation, both from a generational point of view but also from a business point of view, to be very competitive in a market that is increasingly tougher to operate in.

That push in the private sector is happening to older companies. In the public sector, there is a push to move the burden of employment to create a much more fertile environment for businesses to flourish. It's happening at the same time.

Abdellah Iftahy: I think this holds true across sectors. If you take industrial sectors, retail, consumer, banking, you see, in the private sector, the family-owned businesses taking more and more of an active role in order to drive the economy forward.

As Ahmed mentioned, it is not sustainable for the government to be the only one investing. Any healthy economy, going forward, will have to have a healthy balance of government investments and private-sector investments. That's also what drives a lot of innovation, a lot of entrepreneurship. The government cannot be the employer of choice for everyone. I think the private sector needs to take a much larger share on that front, as well.

Simon London: Because, due to demographics, we know what's going to happen to the population—and to your point, we can fairly well predict what's going to happen to government revenues—it's fairly clear where this is leading, unless these transformations are successful.

Ahmed Youssef: I'm very optimistic. Look at the venture-capital space. I mean, people would laugh about this three, four years ago. It was nice to have, but it was not really a source of economic development, a source of innovation, and so on. Today, look at it. It's not just about Uber and Careem or about Amazon and Souq. It's about many other developments that we will hear about in the next four, five years.

The government has created that fertile environment, from countries like Lebanon, where the central bank allocated money for these VC [venture-capital] funds, to the UAE, where you have incubators that have been set up. People were skeptical about them, but we're starting to see the fruits of all these developments today—and the same thing for the private sector.

It's not about creating their own companies anymore, but they're actually investing in entrepreneurs, investing in ideas. Seeing this, and seeing how this happened with such speed—an industry that took maybe 30, 40 years to develop outside has developed here in, literally, five years—let's not underestimate that. This is what, personally, makes me very optimistic about the prospects of the region.

Simon London: You just mentioned Souq. For people who aren't in the region, just remind us of the Souq story. What is it? What happened?

Ahmed Youssef: Souq is the equivalent of Amazon in the region, if you will. It's a marketplace where you can buy pretty much everything. It was established a few years ago. It was quite successful, in terms of growth. It was still at the early stages of development, selling a few products—mostly electronics, beauty and cosmetics, books. It was acquired by Amazon in 2017. It was probably one of the largest deals here, in the region. It shows the importance of the region moving from an energy market to a consumer market, when you see a giant like Amazon prioritizing a deal here in the region.

Since that deal, we have seen a lot of e-commerce platforms taking place. Noon is now the other player that is present in the market that was established here to compete with Souq and Amazon and other ventures coming from Rocket Internet that are present in emerging markets, like Namshi or Wadi in Saudi.

A couple of weeks ago, we were at the World Economic Forum, where the top 100 Arab start-ups were invited, and it was quite impressive. What struck me is the percentage of companies that are focused on technology. Digital and analytics were a massive share of the start-ups, across industries—in education, fintech, retail, advanced analytics, and digital. That's just a great example that the youth bulge can bring a lot if we lay out the infrastructure properly for them to innovate and really create some great concepts that can be exported to Africa and to the rest of the world.

Simon London: This all sounds very positive. I just want to make sure that we're not guilty of glossing over some of the challenges. Again, if I'm a CEO looking at the region from the outside in, some of the stability issues and conflict issues are certainly going to be top of my mind in thinking about a strategy. What's your answer, Ahmed? How do you address that, when that comes up?

Ahmed Youssef: Of course. Look, we're not blind to these challenges. The way I look at it is very different.

If I look back, I moved back to the region 16 years ago. If I had a faint heart, there would be maybe three or four times in those last 16 years where I would've said, "The world is collapsing. I need to go." The idea crossed my mind every single time, be it around 2004, then 2008–09, then recently. There were many things: revolutions, oil prices crashing, and so on. If you really look at it in three-year chunks, then it's not the region you should be investing in.

Simon London: Too much volatility?

Ahmed Youssef: Too much volatility, and it's quite scary. But then, if you step back a bit, and if you look at a much wider time frame, the growth that has happened is, again, unprecedented. Just look at the country we're in.

The Port of Jebel Ali: that was actually set up, and people said, "That's a crazy idea. You know, the region will never be as big," and so on. And look, it's one of the largest and most successful ports.

If you look at the real-estate market here—I'm just focusing on the UAE; I can give examples in many other places—again, people thought when the economic downturned happened, and there were many conflicts all around, "That's it. Dubai will never pick up. There will be empty homes; look at the lights in this area. There is no light." Again, the stock of real estate probably doubled since then. People are still coming and still buying.

I think we have to look at it from that lens. We have to look at the long term. At the same time, it's also important to take a leap of faith that these conflicts, at some point in time, they have to be resolved. They will not benefit anyone. The youth will get the employment. They will get excited with the new technology trends that are happening. They will build their own businesses. There will be a more fertile environment.

We have to believe in this. I have to believe in this, as a resident here. Every citizen has to believe in this to bring this region to its full potential. If we are too skeptical, and we fall into the trap of these geopolitical events, nobody will stay here, and no one will invest in this market. But still, people are investing, and we're still growing, so I'm optimistic.

Simon London: But you will concede that you've got to take a long-term view. You've got to take a through-cycle mentality, and you can't be afraid of a bit of volatility. Because you're going to get it.

Ahmed Youssef: Exactly. You have to expect the volatility. You just have to be prepared to deal with it. Do you fire people when this happens? Do you close factories? Do you keep factories on? So just be very flexible in the mind-set and also know that—believe that—at some point in time, it will come back.

Abdellah Iftahy: Just to add to that, I think instability or volatility has been there, in this region, forever. That didn't prevent the great years of growth that has been here. Between 2003 and 2015, I think, there was double-digit growth across the board.

At the same time, we're talking about the region. The region has pockets of instability, but it's not every country. Today, UAE is one of the safest countries in the world. Again, we have to be very granular in our view of instability and, just as Ahmed said, be able to read those and navigate through those times in a very smart way.

Simon London: On the topic of volatility, let's talk a little bit about oil because, clearly, the oil price will move. This is still a very energy-rich region; therefore, oil has a big impact. Has the region managed to diversify away from oil? And will it be able to?

Ahmed Youssef: I think this is a question that has always been there. Since before I came to the region 16 years ago, it's always top of mind of all the governments, but the urgency was not there. It was something important, it was something they knew they had to do, but it was not very urgent. Because oil prices, even with the decline, were high enough and good enough to be able to pay for expenses and build reserves that are quite solid.

Today, this urgency is at a scale that is much higher than it used to be. That's why we see the push for diversification taken much more seriously. Look at Saudi today, the way they are opening up the market and the push they're actually doing to create industries to serve the local consumer, first, but also to export. We're going to see the fruits of that in the next five to ten to 15 years. Look at Abu Dhabi again, the industries that they've built.

Have we reached our objective? Of course not. Will we reach our objective with the ambition that we've seen? Most likely, yes.

Simon London: So this time, it's for real.

Ahmed Youssef: The urgency is there. You have no option. It's a one-or-zero outcome in this case, and I think everybody realizes that. But at the same time, I have to take a leap of faith and be optimistic that we will do it. Otherwise, I would not be here in the region.

Simon London: So just double-click for me on the government, the public-sector transformation. What sort of things are governments doing in the region?

Ahmed Youssef: There are a number of initiatives that are happening, and it's challenging to list most of them. I will start with the ones that are impacting the private sector quite a lot because I hear the complaints every day.

Subsidies, just taking out subsidies, is one for me that is very obvious—be it on electricity prices, on gas prices. These are very difficult decisions because, in many cases, this was the competitive advantage of the region in the private sector.

Simon London: Cheap energy.

Ahmed Youssef: They had cheap energy through electricity. I had cheap gas. "Great. I will produce. And I'm a superhero." So that's taken away because that's also a cost on the government. It's difficult, in the short term, for the private sector, but it's very important for the long-term competitiveness because now, in the private sector, I'm forced to say, "OK, if I don't have that competitive advantage, how can I adopt new technologies? How can I change my business model? How can I make my employees much more productive?"

I think the second part is tax reforms in many places—mainly in the Gulf and less so in other countries, where VAT [value-added tax] has been introduced recently. One benefit of it is to create transparency on transactions, and it's quite good. It allows us now to have one single source of truth, if I take the simplest benefit of it.

Then there are other parts that are quite important, such as about labor reform. I take the example of countries, like UAE, where labor mobility has improved so much over the last 15 years. Before, you would be locked into an employer. You couldn't leave for a competitor. Your visa had a certain time frame. Today, more and more, for a highly educated and certain type of professional, this is quite mobile, as mobile as it could be in any other market—and probably even more. That, for me, is one part that is quite important, and I foresee more changes on the labor-mobility part because the region is very hungry to attract and keep talented people.

Simon London: So just before we run out of time, we've been through a number of challenges facing the region. In some ways, it feels like we're sort of approaching a moment of reckoning. It feels like governments, certainly, can see a moment of reckoning down the road, and they're responding to that. If I had to push you and say, "Are you optimists or pessimists? Are you strong optimists, medium optimists, or mild optimists or pessimists?," where would you put yourselves on that spectrum?

Abdellah Iftahy: I'm definitely a strong optimist when I look at the demographics, at the intrinsic things that we have here in the region: the new consumers that will take these markets from energy markets to consumer markets; the talent that they offer, with their entrepreneurship and their skill set that is coming up; governments that are taking bold steps towards diversification; a private sector that is willing to take the torch; and finally, natural resources that are still there to fund some of this diversification going forward. I'm definitely optimistic.

Ahmed Youssef: Obviously, I'm quite optimistic, and I urge investors to think about this as they think about any risky investments that they actually have when they invest in a business. If you invest in a start-up, there is no formula that will tell you that it is going to be successful or not. You take a leap of faith on the people that are there. You take a leap of faith on the ideas. You basically say, "Yes, there will be some challenges. We don't know how to fix them, but at some point in time, they will be fixed. Because the idea is right, and the people are right."

I urge investors to think exactly the same way. Either they believe that the reforms that are happening now are going to work—and the idea of this region and what it can bring to the world is something that they believe in—or they just simply don't take that leap of faith. For me, it's just really about a leap of faith. As an individual, also, I've committed my life here, so I'm definitely an optimist.

Simon London: Yes, it kind of goes back to, are you willing to look at the glass as half empty or half full? There's no right answer to that. You just need to decide.

Ahmed Youssef: Absolutely.

Simon London: Yeah. Well, thank you for a fascinating conversation. Thank you, Ahmed and Abdellah.

Abdellah Iftahy: Thank you.

Ahmed Youssef: Thank you.

Simon London: And thanks to you, our listeners, for tuning in to this episode of the *McKinsey Podcast.* To learn more about the issues we discussed today, please visit McKinsey.com or, if you prefer, download the McKinsey Insights app, which is available for Apple and Android.

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