JULY 2012

THE HALF-TRILLION DOLLAR CHALLENGE

Designing Offset Strategies to Build Reputation, Promote Development

Aerospace and defense companies face an unprecedented challenge as the foreign markets essential to topline growth impose new offset requirements that are stricter, larger, and more complex than ever before.

Our analysis suggests governments will have imposed about $500 billion in global offset obligations on foreign companies through 2016. That number is likely to grow as emerging markets move away from penalty payment schemes. A greater emphasis on enforcement of these increasingly sophisticated policies amplifies this challenge. Additionally, the new requirements are often complex, unpredictable, and opaque. Some governments are even lowering the threshold for sales that are subject to offsets and requiring obligations that exceed 50 percent of an awarded contract's total non-indigenous value.

This is especially true for larger, more prominent programs. The old model, which relied heavily on personal connections, was inefficient and often seen — rightly or wrongly — as a vehicle for corruption. It is being replaced as purchasing countries become savvy consumers and government officials refocus outdated bureaucracies on job creation, economic development, technology transfer, and other modern-day priorities.

Executives in the A&D sector are starting to pay attention to these developments, with some taking proactive steps to protect market share by evolving with these offset regimes. Still, the overall environment remains difficult.

Few companies truly understand the global scale of the challenge ahead. The importance of offsets is only going to increase as national governments rely more heavily on them to promote economic development. It is a challenge similar to the one corporations faced with corporate social responsibility (CSR), as those efforts transformed from early ad hoc efforts to major company initiatives that have a critical effect on companies' public perception and overall mission. CSR went from "nice to have" to an accepted and expected business process in many parts of the world.

The same holds true for offsets. As the importance of these offset offerings grows, companies that fail to impose strategic and analytical rigor on their offset proposals and make them as transparent as possible put themselves at a competitive disadvantage and open themselves to unnecessary financial and reputational risk. Bidders' offset policies and proposals are already shaping brand perceptions and influencing procurement decisions.

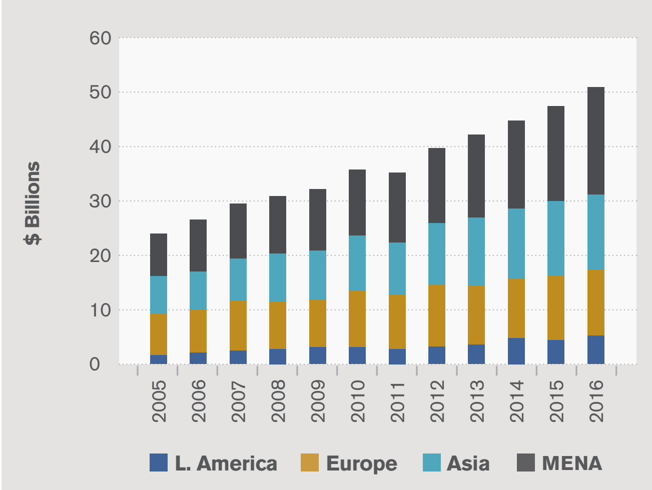
Today, under-appreciating a company's global offsets creates unnecessary risk.

This challenging environment, however, creates a unique opportunity for forward-thinking companies and executives. They can win business and build brand equity in vital foreign markets by taking a holistic approach to offsets that combines the best practices of management and communications in a transparent way.

Because offsets have rarely risen to C-suite attention to the extent that international sales strategies have in today's market, stakeholders and executives should ask themselves the following questions:

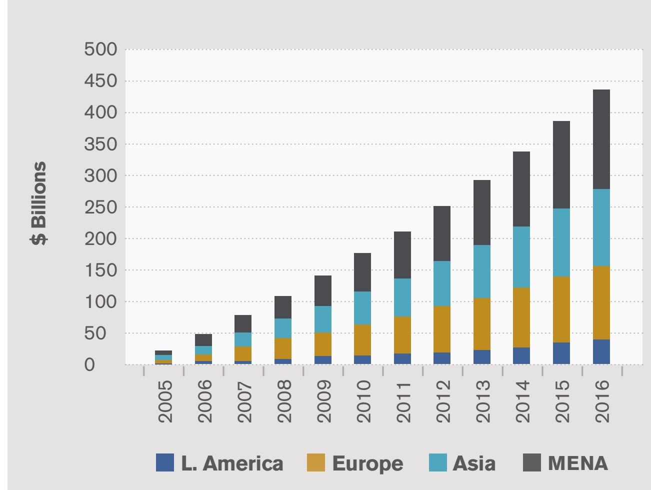
- Is senior leadership aware of how offset policies are changing and what that means to the largest and most pressing offset requirements our organization faces, particularly in countries that are of strategic importance?
- Does the company's internal reporting process track progress in meeting offset obligations?

Global Offset Obligations [Yearly Obligations, 2005-2016]



Source: Avascent 050

Global Offset Obligations [Cumulative Obligations, 2005-2016]



Source: Avascent 050

- Have previous offset successes been communicated to key external audiences?
- Is the offsets process transparent?
- Are offset concepts and proposals vetted with the appropriate business rigor, and are local partners subjected to the same due diligence scrutiny afforded a home market M&A target?
- Are all of the players – business development, project implementation, finance, legal and others – working hand-in-hand on offsets from the very start of a capture process?
- Is the organization capturing lessons learned and best practices regularly and promulgating them throughout the organization?
- Are internal stakeholders aware of the importance of offsets to the capture effort?

If the answer to these questions is anything other than a resounding yes, the following insights will help you begin to right the offset process and deliver new value to your enterprise.

UNDERSTANDING THE CHALLENGE

The sheer size of offset obligations and increasing complexity of policies are fundamentally reshaping the landscape. Offsets are familiar concepts in the A&D sector, but most companies have not kept pace with two changing realities:

> ***Foreign customers are becoming increasingly sophisticated in their offset policies and more rigorous in their enforcement***

Offset regimes are becoming much more sophisticated as offset policies are paired with development objectives. Like the offset policies themselves, these goals vary by country. For example, Brazil is highly focused on technology transfer, while creating jobs and developing indigenous industries are the top priorities in Colombia.

The means by which companies can meet their offset requirements are also changing. For example, the UAE recently began requiring that the majority of offset credits be generated from the net profits of offset-funded startups. Or take India, where they do not allow for multipliers – a fundamental assessment metric found in virtually all other offset regimes.

Finally, countries are changing the size of contracts that incur offset obligations and are enforcing previously ignored rules. Until recently, a company could simply pay the penalty on lapsed obligations; that, however, is no longer an option in many countries, such as Kuwait.

> ***Many companies lack the internal capacity to keep pace***

These fundamental changes are exposing a key internal weakness of companies: their capacity to meet a massive volume of offsets as obligations are spread over dozens of countries and sales. This is a situation that will happen more often in the future.

Many sellers have developed two bad habits. They wait until after the contract is signed to fully address or consider offsets and they treat each one as a standalone event. Such disjointed, ad hoc efforts are needlessly expensive and loaded with undue financial risk. Even companies with robust international sales tend to lack the internal capacity to holistically meet offset obligations. A holistic approach would equally weigh offset requirements with other key customer requirements such as performance and price. Offsets would fall within the purview of legal and business development, and it would be just as important to corporate development and project management.

Compounding matters, there are few outside consultants who can help companies develop a strategic approach to offsets based on independent, data-driven methods that are rooted in sound business fundamentals. This is in sharp contrast to the rigorous approach these companies take to every other aspect of their operations, from mergers and acquisitions to due diligence and public relations.

As A&D companies look abroad to counteract softness in domestic markets, the companies that take the same serious, proactive approach to their offset obligations will have a distinct advantage. There is not a one-size-fits-all strategy, but here are the most important principles for an effective approach to offsets.

5 STEPS TO CREATE AN EFFECTIVE OFFSET STRATEGY

1 **Elevate offsets to a strategic priority for senior executives.** Think of offsets in terms of your overall international growth plan, and not merely as a compliance issue. Make executives accountable for offsets and ensure that their offset strategy seamlessly integrates with global, regional, and country-specific sales initiatives before a bid is submitted or a sale is made. Understanding the offset approach before each sale can increase the chance of winning and will have a major impact on long-term contract profitability.

2 **Educate and broaden the universe of internal stakeholders.** Early education of internal stakeholders on the benefits of a proactive, holistic strategy as part of the sales capture effort is crucial to creating buy-in. At the same time, broaden the set of stakeholders involved in offset discussions to include corporate strategy, risk management, development, and finance, particularly in strategically important countries.

3 **Be visible.** Ensure that your past offset efforts and your future offset strategy are visible to key audiences in prospective markets well before the capture stage. Your corporate reputation in emerging markets and your ability to meet offset requirements greatly influence the decision-making process. A legacy of past successful offset efforts will have the same impact past project performance does — leaving customers at ease with your organization's ability to deliver jobs, technology, and economic development. Educating key external stakeholders on your offset differentiators should be a priority.

4 **Implement business fundamentals.** Business fundamentals, such as financial metrics and planning, are vital when developing offset concepts. They are customer requirements and must be accomplished to capture output credits, which are directly derived from offset performance over time. Offset projects and local partners should be vetted with equal analytical rigor as an M&A target would be afforded in your organization's core markets, all the more so if the offset involves a sector with which your firm has little experience.

5 **Leverage partnerships.** Consider a broader range of partners and create a robust network of partners and advisers: consultants can provide insights and apply best practices and business fundamentals to the process, traditional offset brokers can provide investment ideas and concepts, local partners can provide support and a local footprint. Developing a targeted approach for partnering is a great first step.

SEIZING THE OPPORTUNITY

If someone asked how well your organization is handling its offset obligations, what would you say?

For those who have a binary view of the world, offsets are nothing more than a contractual nuisance, arcane requirements that distort international trade and lend themselves to limited solutions that serve the narrow requirements of buyers and sellers. Boxes are checked. Checks are signed. Money is spent.

It is only the visionary leaders who see the opportunity as offsets evolve from compliance issues to development tools.

For the companies they lead, the strategic use of offsets during the procurement process supports business development activities in key international markets. Because they understand that the stakes are much higher than they used to be, offset offerings are structured to capture new business and offset discharges are designed to build brand equity among important market segments. This results in a vital differentiator that will help smart companies capture market share right as competition heats up for the next generation of foreign defense contracts.

The value proposition is even more obvious for governments, all of which are under intense pressure to generate economic development. With sellers expected to incur an estimated $500 billion in offset obligations through the year 2016, government officials in purchasing countries have an unprecedented opportunity to create jobs, attract investment, and promote sustainable growth at no extra cost to the treasury.

That is an appealing prospect — as long as governments apply the same rigor to offsets as the companies that incur the obligations. In addition to sound business practices, this requires effective use of strategic communications that show the efficacy of activities being funded through these novel funding streams.

The result is a transparent system that generates development opportunities for governments and companies.

GLOBAL OVERVIEW AND METHODOLOGY

Avascent conducted research into the current state of offset obligations to arm companies with the foundational understanding necessary to begin thinking strategically and creatively about how to meet current and future obligations.

Bearing in mind the opaque character of this marketplace, Avascent estimates show that over the last seven years (2005 – 2011) approximately $214 billion in total offset obligations were generated around the world. While exact figures on the scale of discharged obligations are not publicly available, anecdotal evidence suggests a significant portion remain outstanding. Driven by pockets of strong spending in the Middle East, Asia, and Latin America, and by the proliferation of increasingly complex and demanding policies, firms are expected to accumulate an additional $225 billion in offset obligations on new sales through 2016.

Methodology: Data on offset obligations are derived from Avascent 050, a proprietary database and decision support tool on international defense sales. Using past and projected future sales as the baseline, Avascent derived offset obligations through the following:

- Defined sales for countries with active offset policies from 2005 to 2016
- Segmented sales by contractor, country, size, and sales type
- Applied country-specific offset criteria
- Adjustments to Avascent's projections were made for sales not subject to offsets (e.g., trade between members of the European Union) and for programs where a sale is anticipated in the future, but no contract has been awarded

MENA: New obligations derived from Middle Eastern countries are estimated at over $12 billion in 2011 and will exhibit an 8% compound annual growth rate (CAGR) through 2016. This growth is primarily driven by the UAE and Saudi Arabia, both of which have developed more sophisticated offset policies that largely emphasize social and economic-sector interests and the attainment of advanced technologies. For example, the UAE's revamped offset guidelines emphasize profits from newly formed offset ventures, job creation for Emirati nationals, and the transfer of exportable technologies and capabilities. Other countries with robust offset policies include Kuwait and Israel. From 2005 to 2016, an estimated $156 billion worth of cumulative new offset obligations will be accumulated by contractors, a formidable sum to absorb by an economically diverse and sparsely populated region.

Asia: Offset obligations derived from Asian countries are estimated at approximately $10 billion in 2011 and will exhibit a 5% CAGR on new obligations generated each year through 2016. Asian offsets are dominated by the two vastly different offset regimes of India and South Korea, which collectively comprise about 60% of the region's obligations. India's offset regulations have proved to be a challenge for aerospace and defense firms as its stated policy awards no multipliers nor qualifies technology transfer for offset credits, but does require local partnership for foreign providers. Conversely, South Korea offers a more traditional policy with the stated goal of building local production and excess export capacity. Other prominent Asian countries with growing offset demands are Singapore, Malaysia, and Taiwan. Through 2016, an estimated $122 billion worth of offset obligations will exist.

Europe and Canada: European and Canadian offset regimes will generate an estimated $10 billion in new obligations for 2011 but will exhibit only a 3% CAGR through 2016, the lowest rate of the four regions. The lower growth rate in Europe is due to efforts to control military spending and a counter-offset trend (embodied in a 2008 Code of Conduct on Offsets). Despite such developments, many European countries, such as Italy, Sweden, and the Netherlands, have robust policies that demand indirect defense offsets as a tool for providing opportunities to their large defense industries.

Other European countries with demanding offset requirements are Finland, Greece, Poland, Spain, and Portugal. Canada also has a sector-driven offset policy, which requires defense primes to place sub-contracts and investments in Canada's high-tech sectors. From 2005 to 2016, an estimated $118 billion worth of cumulative new offset obligations will have been created.

Latin America: Latin American countries generated offset obligations totaling $2.8 billion in 2011 and will exhibit a 10% CAGR through 2016, the highest rate among the four regions. This growth will be driven by military upgrades and modernization efforts in Brazil, Colombia, and Chile, which have implemented more stringent, formal offset policies over the past decade stressing local production, technology transfers, and broader social benefits.

The Brazilian offset guidelines, for example, emphasize technology transfer, joint development of systems to foster innovation, and training – the last perhaps most prominently showcased in the ongoing FX-2 fighter competition. From 2005 to 2016, an estimated $41 billion worth of cumulative new offset obligations will be created.

For more information, please visit:
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