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U.S. Companies Set Sights On Middle East Arms Market

GLOBAL ARMS SALES

BY ALEKSANDAR D. JOVOVIC

The exodus of U.S. defense executives to the Persian Gulf region was palpable in February as the Abu Dhabi-based IDEX trade show kicked off the year's international defense business development cycle. Most recently, the U.S. government confirmed agreements to provide $10 billion worth of arms packages to Israel, the United Arab Emirates and Saudi Arabia.

Motivated by increasingly ambitious international growth targets, leading U.S. defense firms are justified in giving the region their full attention. In the next five years, it is projected that Gulf nations will invest more than $170 billion in military hardware. Saudi Arabia and the UAE are in the lead, with an impressive $115 billion during that period. Aspiring players include Qatar and Iraq.

But challenges abound for U.S. suppliers, including rigorous competition, complex and drawn out decision making and demanding offset and partnering requirements.

The Gulf countries have proven keen customers across the defense portfolio, with requirements for fighter jets, air and missile defense and land combat equipment. The latter recorded one of the most notable wins for a U.S. firm at the show, with Oshkosh Corp. inking its all-terrain armored truck deal with the UAE worth roughly $380 million.

Unmanned air vehicles took center stage as well, with General Atomics Aeronautical Systems announcing the sale of the export version of the Predator to the UAE armed forces. Traditionally strong on the maritime side, European firms announced several naval contracts, though U.S. firms are also working opportunities in the region, notably in Saudi Arabia.

New competitors are also encroaching, with firms from South Korea, Turkey and South Africa showcasing their offerings, as well as the usual suspects from Russia and China, focused mostly on ground vehicles, munitions and missiles.

U.S. firms may be anxious to book new sales in the aftermath of sequestration, but the Gulf defense markets are a long-term play. And while urgent requirements occasionally rule the day, firms that have correctly positioned themselves for the long haul and developed strong customer familiarity usually reap the rewards.

Arms suppliers lavish time and attention on their domestic customers, in an effort to learn about their needs and tailor offerings to their requirements. Similar efforts are called for in the Gulf, which faces the threat of widespread regional insecurity, distinct political dynamics, post-Arab Spring socio-economic pressures that are increasingly competing with defense for resources and a military acquisition community stretched thin.

Customers in the Gulf are looking for staying power that translates into ongoing support for defense systems and ensures employment, technology transfer, and the development of an indigenous defense industry. Countries such as the UAE are working to change their investment priorities. They are keenly aware of the dominance of petrochemicals in their industrial base, and concerned about the long-term commitment to regional Gulf security of both foreign defense companies and their home governments.

These countries have made direct investments in their domestic defense sectors, a fairly traditional approach practiced in mature defense markets such as Europe. Governments are also encouraging partnerships and joint ventures, tying Western firms to local companies, whose maturity, capabilities and human capital vary greatly.

Not surprisingly, defense offsets — an industrial compensation practice that governments, including those of Saudi Arabia, the UAE and Kuwait, require of foreign providers — are the preferred approach to achieving these goals. Offset programs for these three countries alone could total as much as $80 billion over the next five years.

While sensible from the recipient government's perspective, offsets present a serious challenge for U.S. firms. Viewed as off-balance-sheet liabilities, offset requirements are referred to as "obligations" by practitioners. Accordingly, defense firms have opted to dispense with these requirements through a monetary penalty returned to the end-customer. When that has proven impossible, firms have relied on ad-hoc approaches crafted by local advisors and brokers with mixed results. As of late, countries are striving to streamline offset processes, setting robust requirements, metrics and ambitious goals, with the UAE leading the way.

Innovative requirements, including tying the majority of "offset credits" — the valuation of an offset program developed by a foreign company — to outputs and profit generated by the offset venture has upped the ante for foreign providers. Adding another twist, a U.S. firm's successful offset partnership or joint venture, if not structured and managed appropriately, could turn into tomorrow's direct competitor.

A recent survey conducted by Avascent and Fleishman-Hillard of some 200 offset and international business development leaders across the global aerospace and defense sectors disclosed points of agreement and contention. Respondents were nearly unanimous on the importance of international business to their organizations, and equally convinced of the value of strong offset plans for the success of those very business development efforts in the Middle East and elsewhere.

Saudi Arabia and the UAE rank high among the two dozen or so notable international defense markets. The character of offsets — seen as either an obligation or an opportunity — was more contentious. Corporate offset stakeholders were appropriately optimistic, while senior executives and business development leads less so. The pressure to do more and better on offsets is clear.

Meanwhile, investors and Wall Street remain unaware of the role of offsets despite the importance of international growth discussed on company earnings calls. Recipient governments were not let off the hook, either. Many respondents noted a lack of timely information, opaque decision-making and little two-way communication, leaving stakeholders to rely on informal networks to navigate offsets.

Genuine opportunities in the Gulf region abound. U.S. firms are destined to play a major role in supporting the military capabilities of Gulf States. But robust competition from European and emerging Asian suppliers — driven by price, laxer export controls and a desire among Gulf countries to diversify partnerships with foreign suppliers — is a real challenge.

All this can be countered by early engagement. Product portfolios must be evaluated, adjusted, and in the long term, redefined. Offsets must be taken in stride, as an opportunity to shape the firm's local footprint, leverage partner sales channels and cement a long-term relationship between companies.

Local governments need to step up as well, enabling greater acquisition support and delivering more streamlined processes, greater transparency and better communication. Combined, these steps will allow for the creation of mutually beneficial and lasting defense collaborations. ND

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