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Tank Industrial Base in a Fight for Survival

Defense Watch BY SANDRA I. ERWIN

The Promise and Limits of Foreign Markets

U.S. manufacturers are the ones to beat in the international arms market. Sales over the past two years have exceeded $60 billion, and there are still no signs that distant runners-up in Russia and Western Europe will catch up any time soon.

Pentagon contractors, despite their dominance, need their international arms business to grow substantially if they hope to compensate for declining sales to the U.S. military.

Targets of opportunity do exist overseas. Between now and 2018, countries outside the United States expect to purchase more than $100 billion worth of conventional arms, according to estimates by The Avascent Group, a consulting firm. Half of those opportunities will be in Asian countries, and the other half about equally split between Europe and the Middle East. Countries whose defense markets are legally off limits to U.S. firms, such as China, Russia and Vietnam, were not included in the estimates.

The data crunched by Avascent paint a promising picture for U.S. defense firms, but also illustrate the steep climb they face as they seek a bigger slice of the global arms pie. The Pentagon — projected to spend $158 billion on weapons research, development and procurement in 2013 — is such a huge customer that all other markets pale by comparison. The equivalent investment in weapons by all of Europe, for instance, is $68 billion, followed by $67 billion in Asia and $41 billion in the Middle East and North Africa.

Of these regions, though, Asia will experience the fastest growth in the years ahead, says Avascent partner Douglas Berenson. It will not be long before Asia's defense spending surpasses Europe. He estimates the compound annual growth rate from 2013 to 2018 for European arms sales will only be 1 percent, in contrast to 6 percent for Asia and 5 percent for the Middle East and North Africa.

A handful of countries have been tagged as hot markets — India, South Korea, Saudi Arabia and Brazil. "Every aerospace and defense company is there now," says Jon Barney, also a partner at Avascent.

The most coveted arms deals are likely to be in Asia. "The only defense budgets in the world that are climbing are in Asia," says Air Force Gen. Herbert Carlisle, commander of air forces at U.S. Pacific Command. "We want to expand that engagement." Military leaders overseas are champions of American manufacturers because they believe they can build closer ties with allies if everyone owns the same equipment.

Missile-defense systems are among the most sought-after U.S. technologies. The United States has sold to allies every major system that the Pentagon developed to protect troops from enemy ballistic missiles. More sales are expected, predicts the Congressional Research Service. "There is a potential for significant further sales if South Korea and Australia decide to emphasize ballistic missile defense in future budgets, or if Southeast Asian countries such as Vietnam, the Philippines or Singapore begin to view ballistic missiles as a threat to their security," states a CRS report.

The opportunities clearly are there, but analysts caution against over optimism. In Europe, American firms must contend not only with shrinking defense budgets but also strong protectionist tendencies, Berenson says. "It is not an impossible environment for U.S. suppliers, but it is increasingly difficult."

In the Middle East, there are fewer challenges from domestic industries, but U.S. firms there face cutthroat competition from European arms makers. Russian and Chinese manufacturers also are entering the fray. In Asia, there's a general preference for U.S. hardware, but some of the biggest spenders, including Japan, Taiwan and South Korea, are investing in their domestic industrial base, Berenson notes, which means U.S. suppliers must find a way to work with domestic players.

Barney also warns against the hype that has built around some countries. India is a case in point. "It has opaque acquisition processes," he tells industry executives at the Center for Strategic and International Studies. "A lot of companies are frustrated. They've been there for a long time" waiting for the government to make good on procurement decisions, he says. "India would have a trillion-dollar defense budget if everything that was announced materialized."

Another piece of advice for U.S. firms: Dig in for the long haul. Many U.S. defense companies are not convinced they need a permanent presence in a given country to court customers. The reality is that they do, says Barney. "The 'fly in, fly out' approach by U.S. companies" does not go over well in some countries. "Customers on the ground notice that," says Barney. "I recommend boots on the ground."

Relationships are a "huge deal" in the international arms community, says James J. Lovelace, a retired Army lieutenant general and head of international programs at L-3 Communications, a company that is heavily reliant on exports. About 25 countries make up 70 percent of L-3's business.

Lovelace worries that U.S. firms are not as aggressive as their European counterparts. "When you go downrange to [the Middle East], you see a heck of a lot of Europeans," he says. "The United States shows up but not in the ways others do."

The idea is to not be seen as an "industrial tourist," he says. "You can't parachute in."

By far the most daunting hurdle for U.S. companies will be how to satisfy buyer nations' ravenous demand for "offsets." In the defense trade, offsets are industrial compensation arrangements required by foreign governments as a condition of purchase. Offsets have always been part of the international defense business, and arms sellers view them as a necessary tool for closing a sale. But as the defense market becomes more competitive, buyers will set the offset bar higher than ever, Lovelace predicts. Countries in Asia and elsewhere will need jobs for their exploding populations, he says. They will expect arms sellers to provide those jobs. "This is going to be a big deal in offsets," he says.

As importers jack up their offset demands, multinational companies with a global presence will be increasingly sought by U.S. exporters to help fulfill offset obligations.

Gregory Horton, vice president of electronics manufacturing giant Flextronics, says the company is working with several U.S. defense and aerospace firms to "help extinguish offset credits."

Avascent's forecast shows that, by 2017, U.S. aerospace and defense exporters will rack up a half-trillion dollars worth of offset obligations. "This will be a challenge for every major company," Barney says. Economic development will be sine qua non in any major defense sale, he adds. "Over the years, companies have ignored this."

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