

Survey of Defense Offsets, Global Partnerships, and Industrial Cooperation:

Rising Awareness, Enduring Challenges and 7 Key Steps for Success



Aleksandar Jovovic · Jon Barney

Driven by the increasing economic importance of defense exports and importing nations' desire to grow domestic defense industries, the demand for offsets, industrial cooperation, international partnerships and joint ventures continues to expand. Viewed holistically, these business strategies are a key competency for any international firm, and a foundational element of the defense economy for any nation.

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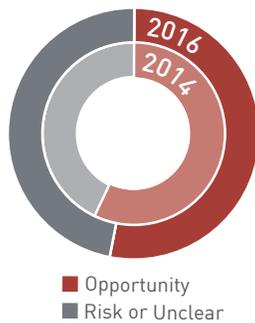
KEY THEME

Given the importance of international sales for Aerospace and Defense (A&D) firms as well as the growing importance of offsets and industrial cooperation across the sales cycle, Avascent recently reached out to leading industry and government stakeholders, gathering highly informed opinions, concerns, trends, and suggestions. We are pleased to share our 2016 survey findings and well as suggest a host of implications and best practices for industry and government in an effort to continue to foster effective, transparent, and timely progress in the sector. Throughout this report, we will also reference our 2014 offsets survey, which provides a baseline and points of comparison.

Rising Importance of Offsets and Global Market Expansion

Our survey results showcase the importance of offsets in the international business sales cycle, but also reflect continued unease with the offset and industrial participation activity set—driven by internal failings and by structural weaknesses. These themes are consistent with Avascent’s experience and we believe they require immediate attention from industry and government alike. But all is not dire: our respondents acknowledge some positive trends and recent progress addressing shortcomings. The task at hand remains **conceiving of the necessary changes, effectively implementing them, while safeguarding the incremental progress to date across the offsets, partnerships, and the industrial cooperation segment.**

[Q] Overall, how does your organization view offsets, international partnership and JVs?



Currently, the core growth driver for US and global defense companies remains export sales. Our results reflect this: the vast majority—94%—report international sales will *increase* in importance. A trend line of such unanimity underscores the growing competitive context of export deals where every differentiator counts, providing an opening to firms that use their offset and partnership offerings to win bids.

Indeed, over 80% of our respondents confirmed this view, a finding consistent with our 2014 results. Interestingly, the number of stakeholders who



argued that offsets, partnerships and joint ventures were “very important” to the contract award process crossed the 50% threshold this year, suggesting a growing awareness that these activities are an integral part of demand-shaping and the business development process. As an important footnote, this stance was highly consistent among both direct offset/partnership stakeholders and their colleagues with only indirect involvement in the sector. As a result, **offsets and international partnerships now command significant attention among senior stakeholders and leaders.** Over three-quarters of respondents report their senior leadership (defined as business unit executives or corporate functions of “vice president” and above) are well informed or integrally involved in the process. One third report their business unit or corporate presidents and CEOs are in the know—an notable change from the early days of international engagement. However, further improvement is warranted.

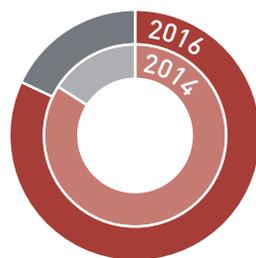
Improving Performance in Offsets, Global JVs, and Industrial Partnerships is Necessary

Industry: Awareness doesn’t equal whole-hearted commitment and enthusiasm does not equate to success. It has been Avascent’s experience, reinforced by this survey, that firms continue to struggle with offsets and international cooperation. The barriers to success are consistent: firms have limited familiarity with local partners and requirements, offsets and similar activities can be disruptive to the established supply chain, and domestic national security restrictions can get in the way, to name but a few challenges. And the survey results support this: only about half of respondents report their organizations view offsets as an opportunity, a result that has held steady in Avascent polling. Less than a quarter of surveyed executives view offsets and international partnerships as a risk—a noticeable decline. Yet a growing number report their organizations have no consistent view on offsets. Negative or ad hoc approaches—held by roughly half of firms—to a fundamental element of international business development remains troubling.

Setting aside the approaches to offset and international partnering, it is also vital to take stock of how well organizations self-evaluate their competitive position. The current trend line, based on comparative results from 2014, is not moving in the right direction. Nearly a third of respondents report increased dissatisfaction with their respective organization's partnership and offsets abroad. Interestingly, a significant minority of stakeholders reports they are uncertain about how well they are doing, suggesting the need for more effective company-wide communication.

Indeed, if there is poor internal communication, articulating success stories and past-performance to the end-customer will suffer.

[Q] Based on your experience world-wide, how important are offsets and international partnerships/JVs during the contract award process?



■ Important
■ Unimportant or Unclear

Returning to the theme of differentiation and the notion that successful partnering and offsets can drive successful international captures, we asked our respondents to consider how their firms stand up to their industry peers. Specifically, our query examined how strongly the respondent's organization prioritized international engagement and how that lined up against industry standards, all in the context of international business development efforts. And while our participants generally report similar trends for their respective firms and industry as a whole, there is a noticeable delta. **A significant number of stakeholders believe their peers—rather than their own organization—place greater emphasis on international engagement.** There is clearly work to be done on competitive analysis around offsets, engaging earlier with business development, identifying and engaging local partners, among a myriad of relevant activities.

Government: When it comes to offsets, governments are equal partners with industry. Although a more detailed analysis of government strategies on offsets and supporting engagement with foreign providers calls for a longer conversation, our survey illuminates to several critical issues. We asked our respondents, predominantly industry-based, to rate transparency and openness of governments on requirements and rules surrounding offsets and industrial participation. The response was stark: **less than a third of respondents view government actions as satisfactory, and the number of openly dissatisfied voices has grown since our 2014 survey.**

We also asked our respondents to score countries on how effective they perceived the offset/defense industrial policies of 27 countries. Several classifications emerged:

- 1 Outperforming:** Canada, Norway, and Singapore, among others
- 2 Middle of the Road:** South Korea, Poland, and Taiwan, among others
- 3 Room for Improvement:** Kuwait, Greece, and India, among others

There are a host of objective reasons for superior or sub-par performance. Indeed, the degree of flexibility versus regulation in offsets, how stringently offsets are enforced, broader ease of defense procurement, maturity of local partners, and a host of other characteristics can color these assessments. Aware of these nuances from our consulting engagements with industry and government, we underscore the need for more study and context but also appreciate that **best practices and identifying and applying benchmarks are vital elements of improvement. These are steps that no firm or government—leader or laggard—can afford to ignore.**



Diverging Opinions: How Scale and Focus Impact Views

The depth of expertise and high volume of responses in Avascent surveys allows for insightful analysis based on respondents' positions. As a starting point, we've dissected some of the responses based on functional roles, primarily whether respondents had a day-to-day "direct" role in offset and international partnership management or whether they had more "indirect" insight or oversight of the process. As a second step, we examined differences between a) the largest firms, those boasting over US\$5 billion in annual revenue and b) those below that annual threshold. We uncovered considerable similarities, and a handful of interesting departures.

Degree of Offset Focus: Perhaps counter-intuitively, stakeholders *outside* the immediate offset/partnership realm were more likely to identify offsets and international partnerships as an opportunity—by some 18 percentage points. Attributing this pessimism, or perhaps realism, among dedicated offsets and partnership stakeholders is complicated and requires more analysis. However, at least some of this divergence is the result of widespread feeling among

practitioners that they do not receive the internal support and recognition their mission requires.

Less surprising was the fairly modest divergence among “direct” and “indirect” respondents on the issues of satisfaction with their respective firms on offsets and partnership: direct practitioners were slightly more pleased with their organization’s performance, perhaps an understandable professional bias. Among respondents not voicing satisfaction, practitioners held notably *more negative views*, while indirect stakeholders were more likely to voice *uncertainty*. This is a logical outcome of their less pronounced insight into the details and outcomes of offset engagements, joint ventures, and other international partnerships.

A similar trend may be afoot with host-government transparency. As we noted, there was significant displeasure across the board, according to the survey, but stakeholders with indirect involvement in offsets and international partnerships tended to be more critical of host governments. Both sets of questions indicate the need for more regular and detailed communication across offset stakeholder communities within each organization and with government agencies.

Finally, we return to the theme of prioritization of offsets and international partnerships in the business development (BD) process. The significant spread between the perceived internal priority and that of industry was present within both cohorts, but the divergence was very pronounced among stakeholders that are indirectly involved with offsets/partnerships. Put differently, this diverse grouping of professionals and leaders displayed a very significant concern that their respective firms were lagging in integrating offsets/partnerships with international BD efforts.

Revenue-Based Differences: The largest firms—those with US\$5 billion and above in annual revenue—reported more inconsistency in their organizations’ approach to offsets. At first glance this may seem counterintuitive as larger firms typically have more experience in the sector. However, such expertise is often hard to *consistently* apply among large and diverse organizations with significant turnover and complex internal structures or BD approaches.

Following that trend, the survey’s smaller firms were notably more satisfied with the progress their organizations were making in the offset and partnership realm. This could be the result of several drivers: more limited exposure to offsets and partnerships, greater ability to license or share technology, or other themes. Similarly, smaller firms were also somewhat more positive about host-

government transparency and openness. This is somewhat surprising, bearing in mind their more limited BD capabilities and presence abroad, as a function of their smaller size and less frequent end-customer interaction.

Indeed, many of these firms, to the degree they interact with offset authorities under the umbrella of a foreign prime contractor, may directly benefit from their larger peers' offset and partnership expertise. The smaller firms appear to convey such self-awareness in a related question. The spread between their respective firm's focus on offsets/partnership and the broader A&D sector is significant.

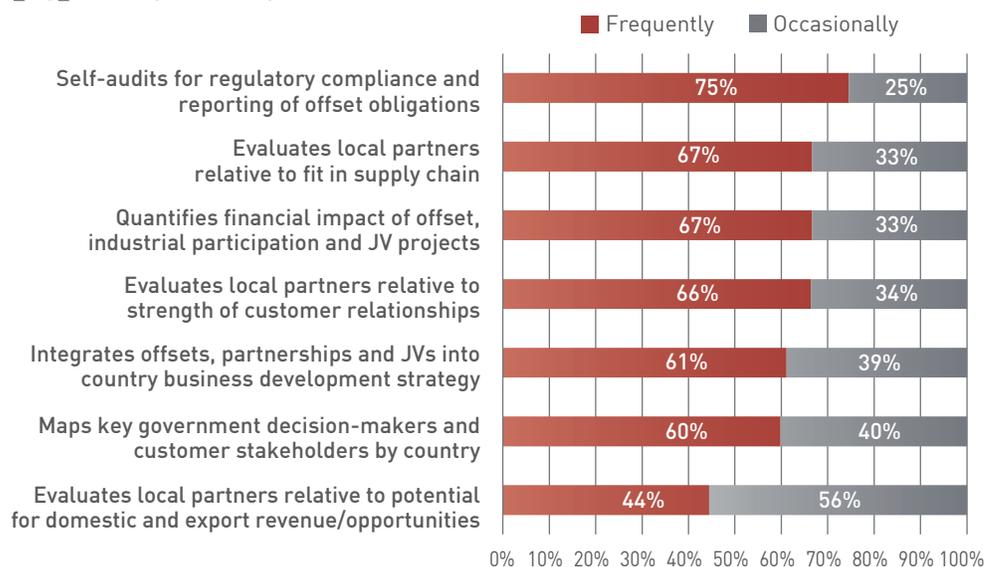
7 Steps for Success

7 Steps for Success in Offsets, JVs, and Global Partnerships

Successful international engagement—across offsets, industrial cooperation, and other engagement such as partnerships and joint ventures—requires methodical and consistent processes. We propose seven requisites for success in offsets, joint ventures, and industrial partnerships.

As a rule, companies should be showing consistent preparedness in these following areas. If shortcomings are revealed, Avascent recommends a diagnostic across these areas to identify performance gaps and areas for improvement. These seven steps then provide a roadmap to implement future changes. Needless to say, many of these activities are highly relevant to government

[Q] How often does your organization employ the following best practices for global offset, partnership, or JV efforts?



stakeholders in the sector as well, with some targeted customization. **The themes in yellow and orange below signal particular areas of existing weakness that firms must guard against.**

Compliance Rules the Day: Consistent with past responses, Avascent's findings suggest that firms regularly conduct regulatory and audit analyses of their offset obligations. This is in line with experience: offsets have traditionally been a requisite compliance-focused activity that needs to be satisfied rather than an opportunity to develop a commercial advantage.

Assessing Supply Chain Fit is Middling: Respondents suggest firms apply a mediocre effort in evaluating basic partnership characteristics. They make some effort to determine the partner's fit in their supply chain. Even then only a third of respondents reported their firms did so *consistently*.

Quantifying Financial Impact: Firms are not evaluating the financial impact of offsets in a majority of cases. From Avascent's experience, the financial evaluation of offsets, joint ventures, and industrial partnerships also tends to involve corporate development organizations later than is optimal. Many firms pursue a one-off tactical venture rather than approach offsets, joint ventures, and industrial partnerships as a strategic pursuit.

Assessing Partnerships Relative to Customer Relationships: Companies are even less prone to evaluate the customer relationship of their local partners. The result often means companies miss potential market opportunities that local partners can develop with them.

Country Strategy Lacks Focus on Offsets, JVs, and Industrial Partnerships: Roughly one fifth of our survey respondents report their firms regularly integrate offsets and partnerships into their formal country strategies. Given that local customers view these partnerships, offsets, and JVs as integral to their relationships with foreign providers, companies appear to miss a significant opportunity to make the optimal use of these elements in their international growth strategies.

Country Customers and Stakeholders Not Mapped: Respondents recount modest performance in their strategy development efforts: only a quarter report they consistently map out key government and customer stakeholders by country. Avascent views this as a significant missed opportunity for firms as strong customer relationships are neglected or missed entirely.

Evaluation of Partner Potential is Disregarded: The most promising element of partnerships and international engagements is tied to the most glaring failing revealed by the survey: less than 20% of firms regularly evaluate local partners based on potential for revenue growth, whether in the host country or in export markets.

Pockets of Excellence

Pockets of Excellence: Implementing Best Practices and Innovation

Our findings above suggest a set of themes that can improve the offset and international partnering process, thus increasing the rate of success for firms and governments alike.

Advice for Companies

- Conduct internal diagnostic of seven key areas for effectiveness with offsets, JVs, and industrial partnerships
- Develop offset programs and partnerships with the long-view: what is the broader potential for commercial adjacencies and exports outside the host country?
- Prepare for co-development: increasingly it is seen as providing both know-how and a way around simply surrendering IP; co-development may result in new research and development (R&D) funding at a time when R&D spending by home governments is shrinking
- Capture more of the value-chain: consider investing in-country to capture more of the value-chain while also providing training, know-how, and economic benefits to the local economy and partners

Advice for Governments

- Embrace a whole-of-government approach: appreciate the role of partner stakeholders (defense, procurement, finance, trade & economy), and understand that an uncoordinated approach hampers international engagement with foreign partners
- Improve offset credit accrual and banking: by emulating market principles, programs will improve in efficiency and quality
- Innovate to support SMEs: multipliers alone will fail to inject the desired number of small and medium sized firms into partnerships and industrial cooperation efforts

- Consider targeted indirect offsets: developing a clear rationale and guidance for industry, however, will optimize impact and ensure that only strategic sectors are supported

The themes above are only the beginning of a more detailed dialogue that will lead to improvements to both business results and government processes. Both entities find themselves at an inflection point, as global defense spending is driven upwards by geo-strategic challenges while broader economic conditions require equal attention. Developing a win-win model for defense and security investments in the broader economic context is more important than ever for industry and government.

Avascent extends its appreciation to GOCA and DIOA for sharing the above mentioned survey with their members.

Our Respondents: Avascent surveyed select senior stakeholders across the A&D sector in February 2016, posing 18 rank-order, multiple choice, and open-ended questions. Over 140 responses included broad participation across function and leadership position, from managers to CEOs. Roughly half of respondents had direct offsets responsibilities, while others came from corporate, business development, management, and other functions. Approximately 80% of our respondents come from organizations with more than US\$1 billion in annual revenue, while the remainder represent smaller firms, government, and other stakeholders. The majority of our respondents represent US firms. The respondent demographics of our 2014 survey were consistent with this most recent survey effort.

About the Authors

Aleksandar Jovovic is a Principal at Avascent where he counsels clients on a broad spectrum of critical issues involving strategy, value-creation, and new market penetration. His sector expertise encompasses aerospace & defense, services and infrastructure, public sector markets, and economic development. Alek has played a major role in expanding Avascent's international practice, focused on growth and strategy development. Previously, he was a consultant at Vantage Partners and CENTRA Technology Inc. He has also held research positions at the Brookings Institution and Georgetown University. Alek holds a M.A. in International Relations & Economics from the Johns Hopkins University School of Advanced International Studies (SAIS). Alek is a frequent author of articles and publications on international affairs and business issues. For more information, contact: ajovovic@avascent.com.

Jon Barney oversees strategy, consulting, and M&A engagements for Avascent's aerospace, defense, government services, and technology clients worldwide. His areas of focus have included international strategy expansion, offsets, innovation and adjacent market strategies, and growth through M&A. Prior to joining Avascent, Jon served as an Executive Director in Russell Reynolds Associates' Aviation, Aerospace and Defense Practice. Jon has been a frequent speaker on business strategy at venues such as the World Economic Forum, The Aspen Institute, and Renaissance Weekend and has been published in the Harvard Business Review. He has served as a Board member of the Harvard Business School Club of Washington, DC and is a member of the Economic Club of Washington, DC. He served on the Aerospace & Defense Advisory Board of Fairholme Capital Management. For more information, contact: jbarney@avascent.com

About Avascent

Avascent is the leading strategy and management consulting firm serving clients operating in government-driven markets. Working with corporate leaders and financial investors, Avascent delivers sophisticated, fact-based solutions in the areas of strategic growth, value capture, and mergers and acquisition support. With deep sector expertise, analytically rigorous consulting methodologies, and a uniquely flexible service model, Avascent provides clients with the insights and advice they need to succeed in dynamic customer environments.

AVASCENT

US Office
1615 L Street NW, Suite 1200
Washington, DC 20036
Tel: +1 (202) 452 6990

Paris Office
59, rue des Petits Champs
75001 Paris
Tel: +33 (0)1 73 77 56 19

London Office
Portland House, Bressenden Place
London SW1E 5RS
Tel: +44 (0) 20 8282 6357

www.avascent.com

