

Localisation in military industries

A perspective on industrial
development in the Saudi
Arabia's defence ecosystem



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Introduction

Over the last few years, the Kingdom of Saudi Arabia (KSA) continues to hold the largest defence market share in the MENA region, comprising approximately 9% of KSA's GDP. Globally, the region is amongst the five largest spenders, having invested up to SAR 6,000 Bn in the industry. As localisation efforts in all industries are being supported by Saudi Vision 2030, the defence market presents significant opportunities with targets set to increase local military procurement by 48%.

In the years to come, defence spending in KSA is expected to show continued growth with a Compound Annual Growth Rate (CAGR) of 7%, fuelled by political and security instability throughout the MENA region.

Saudi Vision 2030, a strategic framework proposed by the Saudi government, has put an emphasis on achieving localisation in the defence sector. The Kingdom specifically expresses its hopes of localising "more than 50% of spend on military equipment and services by 2030."

In order to better fulfill their localisation objectives, the government has divided the military industry into various priority areas with subsequent localisation targets for each. Examples of notable priority areas include ammunitions, arms, navy platforms and structural components, as well as maintenance and repair operations in navy and aviation.

The need for localisation is driven by various factors. This includes diversifying the country's income sources and decreasing import dependency. Additionally, there is a growing demand to create jobs for Saudi nationals and to continue training and educating local engineers.

KSA established the General Authority of Military Industries (GAMI) responsible for overseeing, regulating and enabling the defence sector. GAMI also manages military procurement and operational contracts for arming the military.

In parallel, the Saudi Arabian Military Industries (SAMI) was established in 2017, a national champion which will act as a vehicle to deliver upon the most strategic localisation targets. SAMI established joint ventures between national Saudi companies and international military production companies. They are mainly responsible for consolidating local companies and assets and aims to develop new and existing local industries and new technologies.

This paper aims to inspire discussion with a wide audience in military industries including regulators, investors and other stakeholders. In it, we provide a comprehensive view of the industrial development landscape and localisation of military industries in KSA. Our objective is to provide a broad framework for understanding the market, identifying opportunities, introducing a framework for utilising local capability and measuring the health of the sector.



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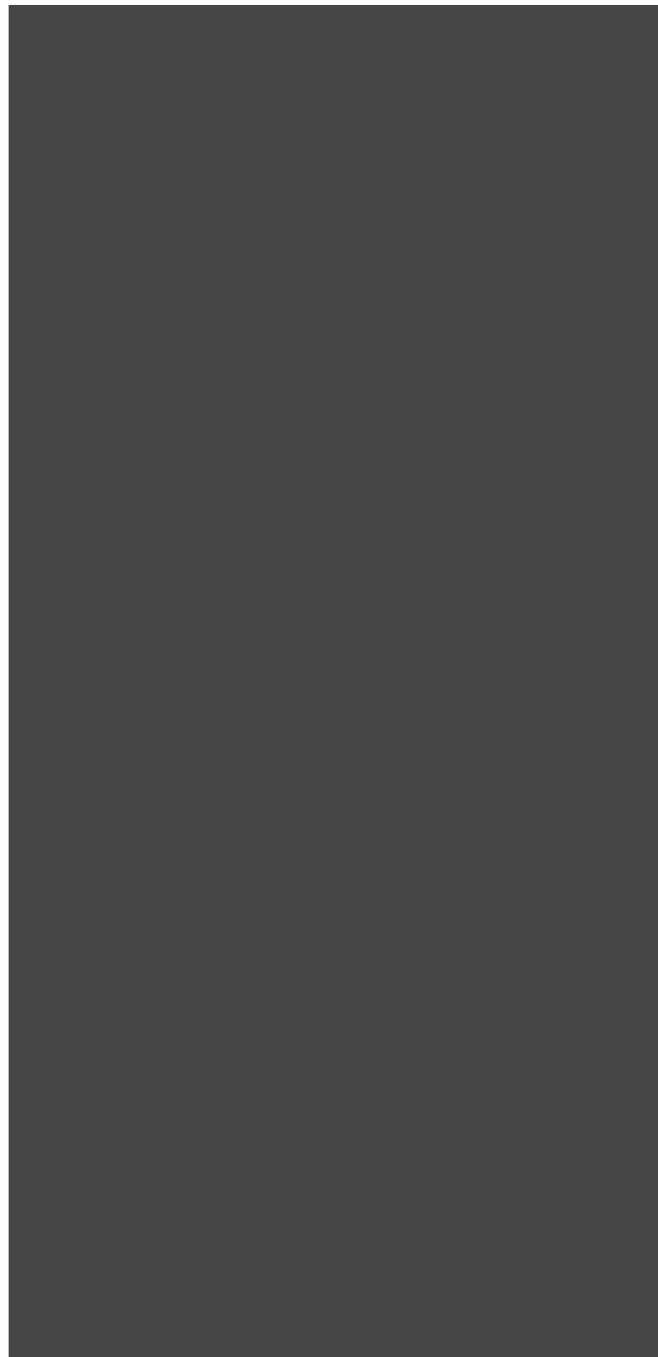
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An evolving market
landscape ideally
positioned for
investment



An evolving market landscape ideally positioned for investment

Between 2015 and 2019, KSA has been the largest arms importer in the world. KSA imports its arms primarily from the United States (73%) and United Kingdom (13%). Less than 1% of arms are imported from China and Russia. The demand in the defence sector is expected to increase at a CAGR of 3-4% with the output of local defence manufacturers mainly contributing to this growth. In this context, output is defined as the sector production volume. This includes all intermediate goods purchased as well as value added through compensation and profit.

KSA has invested significantly in cybersecurity, one of the priority sectors earmarked for localisation by GAMI and SAMI. To drive this agenda, the National Cybersecurity Authority (NCA) was founded in 2017 by Prince Mohammed bin Salman College of Cybersecurity. Increased interest and investment in cybersecurity is likely to contribute to the growth of national cybersecurity capabilities and production abilities.

Aerospace, drone regulation and the space industry are other growing sectors in the defence market that have experienced increased investment, and the government has signed contracts with several players in these fields. Notable contracts include the 2015 agreement between Boeing, Alsalam Aerospace Industries, and Saudi Aerospace Engineering Industries (SAEI) to set up a helicopter MRO facility in Saudi Arabia.

In addition, the 2017 agreement with BAE Systems has allowed the creation of a final assembly line production facility in KSA.

Beyond these agreements, local production in KSA is restricted to licensed production, maintenance, repair and overhaul activities (MRO) of North American and European equipment. Also included in these restrictions are the production of small arms, munitions, defence electronics and armored vehicles. Currently, local production does not contribute significantly to KSA's exports. Efforts to increase foreign investment through domestic defence companies along with improvements to KSA's operational environment, can lead to long term growth.

At present, the revenue generated by local defence companies in the ecosystem is around SAR 160 Bn, while KSA's GDP is SAR 3 Tn. This implies that the defence industry currently contributes less than 1% to the KSA's total GDP and highlights opportunity for growth.

In 2019, foreign direct investment (FDI) stock was estimated at SAR 885 Bn, with a CAGR of around 7%. This demonstrates the opportunity to leverage FDI as a mechanism for stimulating this sector and aligns with the Saudi Vision 2030 target to increase the contribution of FDI to GDP by 50%.

Investment opportunities within the KSA defence industry

KSA players contribute to the defence value chain, and possess a global edge in the area of raw material products used in the manufacturing of defence-related machinery and equipment.



Cross-platform technologies are examples of defence-related technologies that increase interoperability and operational effectiveness across military platforms.



This technology has been prioritised by KSA as it stimulates technology transfer into the Kingdom. In the defence industry, high-growth goods and services cover day-to-day logistics. This includes housing, catering, ventilation, capacity development and training which are all crucial in supporting the nation's forces.










A shift towards
localisation and
industrial
development




A shift towards localisation and industrial development

We conducted a study that analysed offset and localisation efforts across India, South Korea, Turkey and Canada and found that successful localisation programme require the following:


-  Linking Acquisition and Procurement (A&P) of military equipment with the industrial agenda
-  Placing a heavy emphasis on national R&D programs, with R&D being a driving force behind industrial development
-  Militaries working hand in hand with their defence industries in order to benefit more through stronger supply chain security, more flexible delivery options and better price points
-  Ensuring strategic planning of offset and localisation rather than including it as an afterthought in contractual negotiations

Country	India	Defence expenditure as % of GDP	2.5%	
Total offset value	\$12Bn	Year Offset Policy was introduced	2005	

- Success Factors**
- Large number of state defence companies established for a long time
 - Dedicated R&D agency
 - Clearly articulated and elaborate procurement process and local content mandates

Country	Turkey	Defence expenditure as % of GDP	2.2%	
Total offset value	\$25.1bn	Year Offset Policy was introduced	1991	

- Success Factors**
- Applicability of offsets on both domestic and foreign players
 - Focus on exports
 - Generously backed R&D activities and incentives for manufacturing investments

Country	Canada	Defence expenditure as % of GDP	1.3%	
Total offset value	\$31.3bn	Year Offset Policy was introduced	1989	

- Success Factors**
- Strong focus on exports with a focus on SME participation
 - Ensuring that the domestic industry is capable of absorbing investments
 - Foreign Trade Zone allowing for setting up businesses without restrictions

In comparison to these benchmarked countries, KSA invests a much higher percentage of its GDP in its defence sector. They have already begun developing dedicated R&D agencies and establishing state defence companies. In the long run, KSA would have to invest more heavily in Research and Development facilities, build stronger supply chains, prioritise enhancing the current infrastructure for localisation, acquire plants and equipment and develop domestic technical expertise to manage these facilities. Defence players within KSA would require the support of the government in these areas to establish a stronger presence nationally and perhaps even in regional and international defence markets.

A framework to leverage existing industrial capabilities and investment

Several types of cash and non-cash government incentives exist to better position investors within the KSA defence sector. Notable examples include G2G lobbying, favorable loan structures and capital funding, privileged pricing on raw material, utilities and land access, advantageous import/export structure and tax regime. All incentives are placed to ensure defence players in KSA are situated in an ideal position to compete globally.

Several challenges may emanate from establishing a localisation agenda in KSA. Specifically, there are opportunities to formulate an integrated strategy, enhance governance, and introduce favourable procurement laws to enable capabilities and minimise the gap in the local capability of the workforce.

We are well-positioned to address some of these challenges that could hinder the success of military localisation. A typical journey for industrial development and localisation can be seen in the milestones illustrated to the right.



A

Localisation strategy
How to enter supply chain?

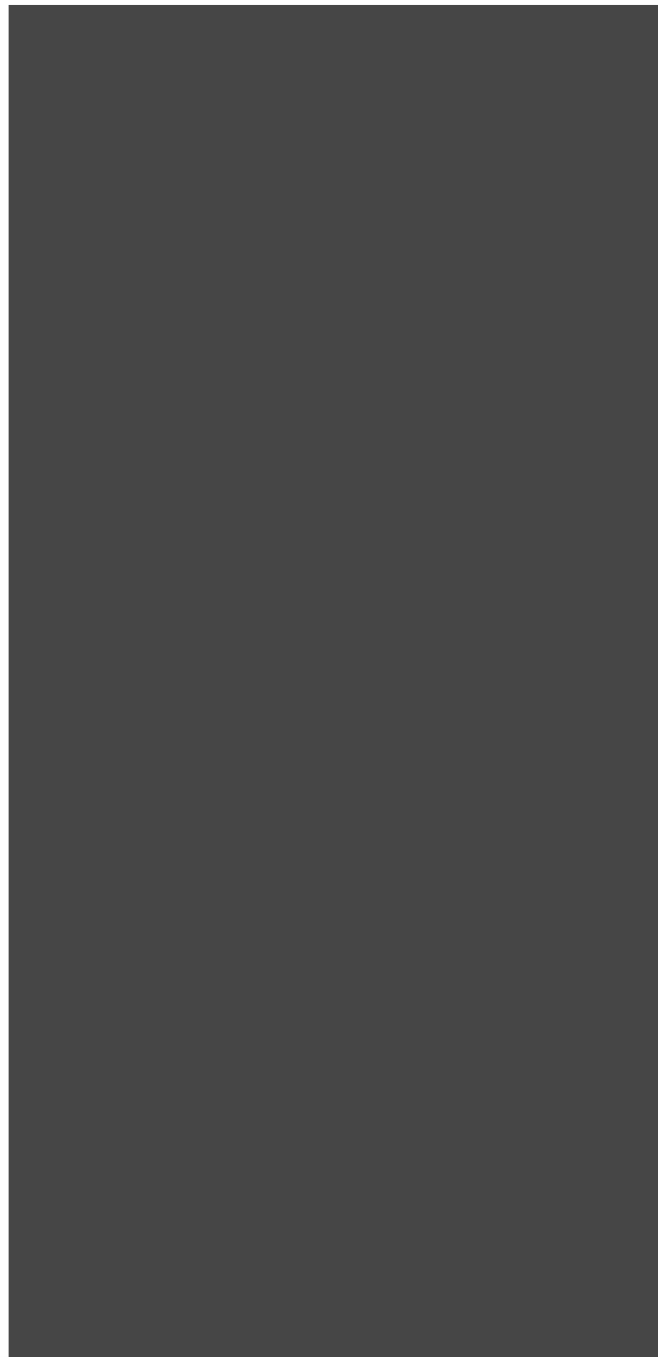
B

Strategic optioning
How to maximise value delivery?

C

Structuring support
How to unlock partnerships?

Measuring the health of the sector



Health of Military Industries (HMI) Index

It is important to measure the HMI to:

Beyond these phases and steps towards localisation, it is important to continue to monitor the progress and needs of the Kingdom's 11 priority military industries. Establishing the Health of Military Industries (HMI) index could be a helpful enabler to measure the health sector along the localisation journey.

The index would assess several comprehensive metrics to help form a better understanding of the health of the military sector.



Effectively analyse the gap in capabilities of the industries

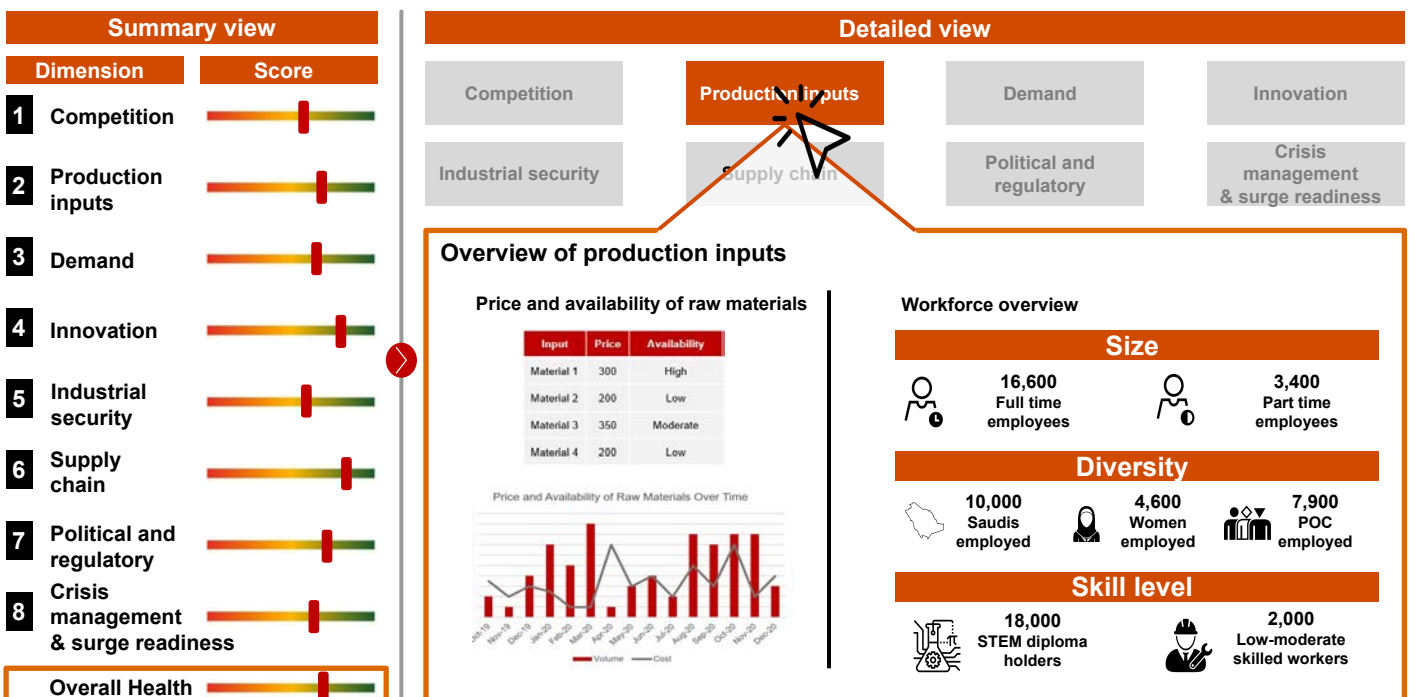
Consistently monitor their process of the priority industries

Efficiently manage the needs of these industries

Comprehensively inform policy and decision making

Increasingly identify opportunities for investors to focus on

The health of the industry can be measured through the HMI and visualised through a dashboard*

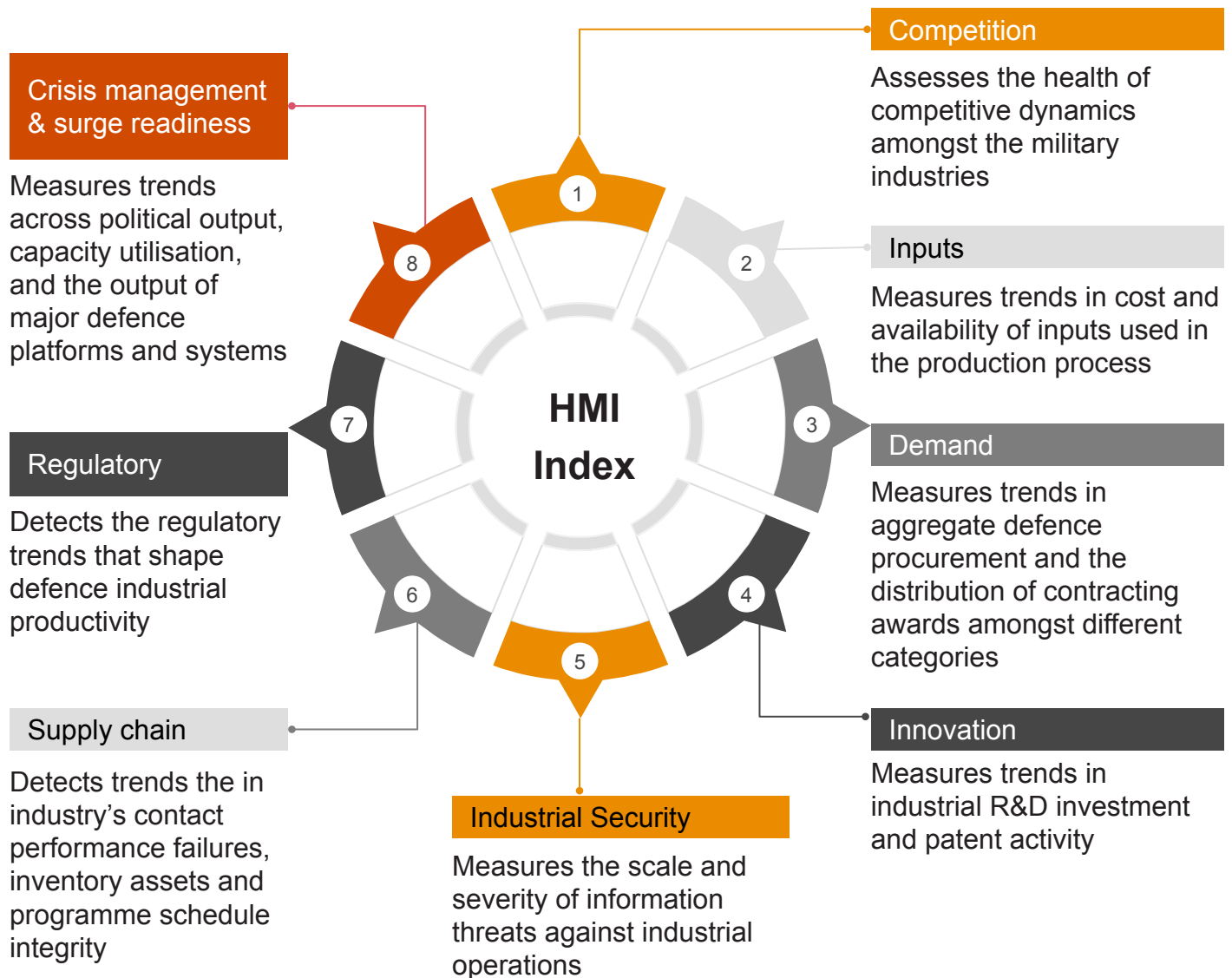


*This dashboard is illustrative

Health of Military Industries (HMI) Index

The HMI index aims to cover a number of KSA defence industry aspects. This includes platform and structural components, defence electronics, weapons and missiles, maintenance and repair operations, cyber warfare, fixed wings, rotorcraft, unmanned aerial vehicles (UAV), land, navy and personal equipment.

Eight potential dimensions for the health of the sector:





Conclusion

KSA has already made significant progress towards localisation and industrial development. To build on this momentum, key areas of opportunities have been identified to support this growth. Market size, investment, capitalisation of existing key industrial players and an effective sector monitoring system is pivotal for KSA's ambitious journey.

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