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Redesigning offsets for the 21st century

**How to make offsets
successful**

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Executive summary

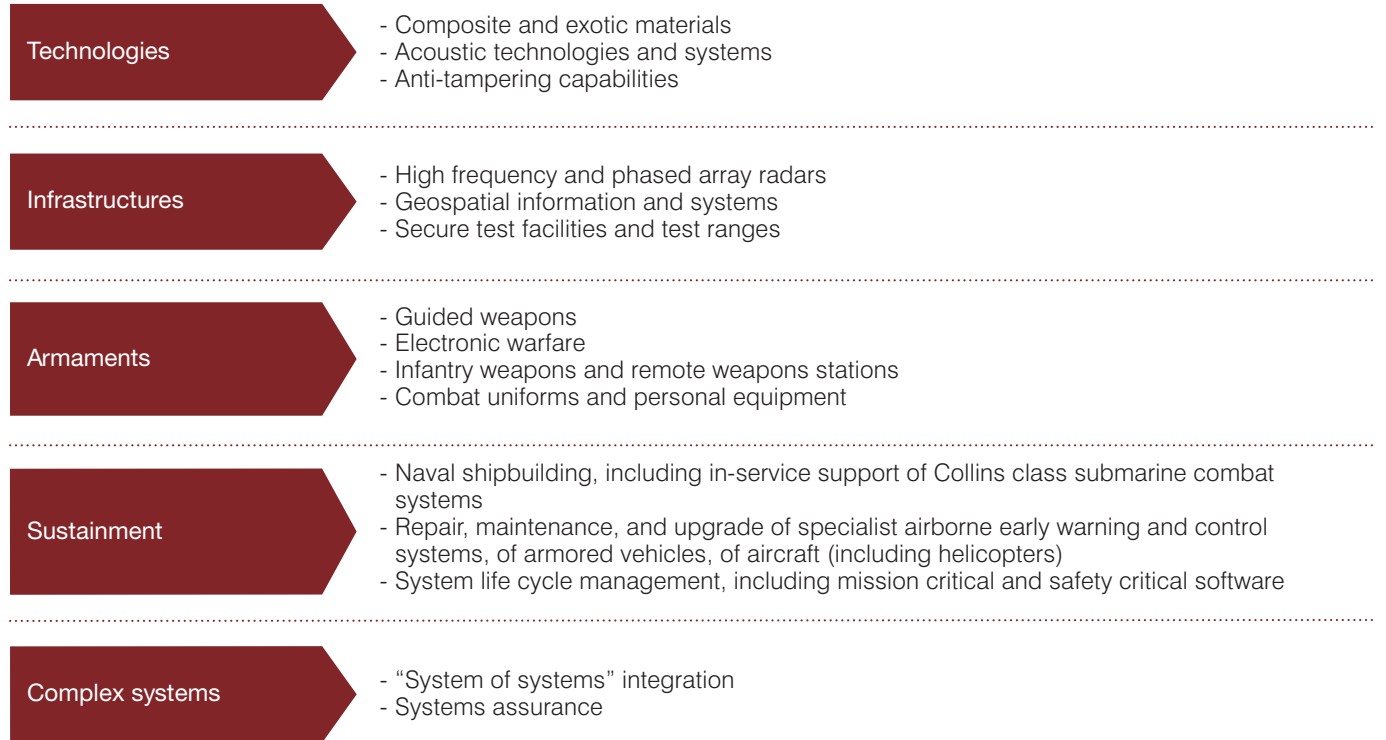


Traditional offsets have sometimes been controversial, but the nature of offsets has evolved significantly over the past decade into more sophisticated commercial partnership agreements that produce clear, long-term economic benefits for both buyers and sellers. For sellers, offsets can help establish global development capabilities and access to emerging markets. For buyers, especially in emerging countries, offsets are a way to accelerate their own aerospace and defense development. At the Global Aerospace Summit 2014 in Abu Dhabi, offsets were addressed in a dedicated strategy session. International contractors, original equipment manufacturers (OEMs), and governments offered their opinions on what make offsets successful. Some of these include: buyer and seller alignment on the business and strategy; a long-term approach to the relationship; good communication and transparency; and having a single government agency responsible for the offset to avoid confusion and conflicting demands. However, Strategy& has found that before any offset agreement is struck, governments must first develop a national industrial strategy and policy that sets and articulates national goals and establishes a coherent approach to pursuing those goals. These national goals can include the capabilities (military and industrial) to be built locally, job creation, and economic development. A good example of such a clear capability strategy is Australia’s 2012 “Defence Capability Plan” (see *Exhibit 1, page 4*).

Exhibit 1

Australia has clearly articulated its defense capabilities strategy

Core Elements of Australia's Defense Capability Plan



Source: Australian Government, Department of Defence, "Defence Capability Plan," 2012

The importance of offsets

Emerging market governments are in a strong position to develop their domestic aerospace and defense industries. Military budgets are being cut in industrialized countries whereas many emerging market countries are spending large sums on aerospace and defense. As a consequence, emerging markets can now leverage their aerospace and defense spending to fulfil national goals for in-country defense capabilities and general socioeconomic development. These are important goals because domestic aerospace and defense industries bestow important benefits. These include high-quality, high-tech jobs, the “spillover” effect of aerospace and defense technologies on other economic sectors, national pride, and greater room for maneuver in security and foreign policy that comes from greater domestic control over these industries.

However, the difficulty of developing aerospace and defense industries is considerable. Governments in emerging markets routinely allocate a large portion of their aerospace and defense spending to foreign contractors, often because local companies cannot meet their needs. Over time, this pattern becomes self-reinforcing. Local providers, deprived of the opportunity to fulfill important contracts, do not improve sufficiently to replace foreign suppliers.

Maintenance and repair is a good example. Often commercial airlines and the armed forces can contract local companies only for minor maintenance and repair jobs, because these firms lack the technical expertise to maintain advanced systems.

The offset evolution

For decades a number of governments have tackled this problem through the use of offsets, which are industrial or commercial compensation practices required as a condition of purchase of defense articles and/or services. Traditionally, offsets took specific forms such as co-production, licensed production, sub-contractor production, overseas investments, technology transfer, and countertrade.

The U.S. and the European Union (E.U.) have officially discouraged offsets in the past as market distorting. However, they tolerate them because they understand that to compete on the world stage U.S. and E.U. firms must often offer them. In addition, the nature of offsets has evolved significantly over the past decade into more sophisticated, long-term commercial partnership agreements.

In Turkey, for example, offsets are a means of obtaining revenues, exports, employment, and, most important, skills and technology transfer and training. Turkey is a very significant purchaser of defense equipment from Western firms and puts a stronger focus than most other countries on military capability building. It insists on the maximum possible extent of offsets to boost national output and employment.

Sikorsky has recently signed a contract to supply 109 S-70 Black Hawk military utility helicopters to Turkey. The state-owned Turkish Aerospace Industries (TAI) will build the aircraft under license, modifying them to local specifications, and will name them the T-70. The total program is worth US\$3.5 billion. Also, Sikorsky will provide over \$1 billion of training and maintenance work for TAI over the next 10 years, will expand its Alp Aviation joint venture (with Turkey's Alpa Group) dynamic components manufacturing facility, and will incorporate Turkey into its global supply chain.¹

Elsewhere, the United Arab Emirates (UAE) is growing its fledgling aerospace and defense industries through state ownership and particularly Mubadala, and its subsidiary Strata, and Tawazun (all in Abu Dhabi). The offset policy set in 2010 focuses on technology transfer, employment of Emirati citizens, and a system of credits that values net profitability and export sales in favored fields such as advanced materials, precision manufacturing, and electronics. Annual milestones have been introduced over a seven-year period.

The Global Aerospace Summit 2014 in Abu Dhabi discussed offsets in a specially dedicated session. During the conference, international contractors, OEMs, and governments provided their views and experiences of what make offsets successful.

The seller's view of offsets

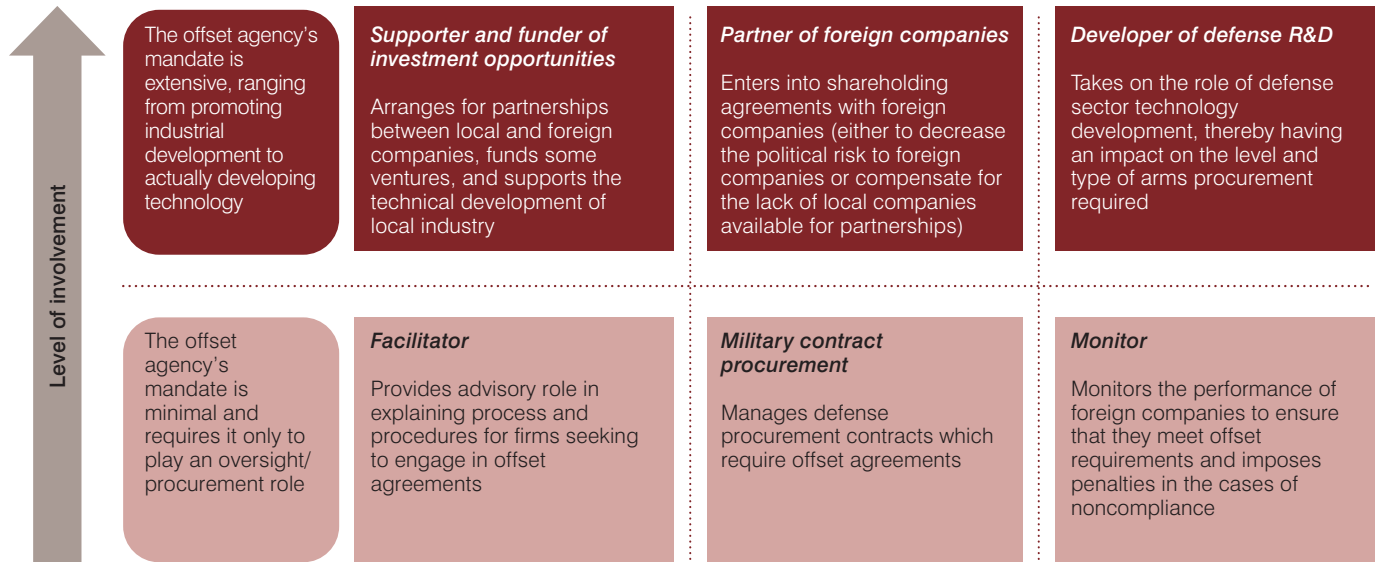
From the seller's perspective, offset agreements need several key characteristics to succeed.

- First, the two sides must align on the business and strategy behind the deal, which needs to make commercial sense. It cannot simply be a giveaway. For example, one panelist noted, sourcing local operations through offset agreements in emerging markets is a way to create more robust, resilient global supply chains.
- Second, agreements need to be long term and avoid a “hit and run” approach. The two sides are more likely to strike fair, mutually beneficial deals if they expect to work together over several years. Panelists noted that a good example of this long-term approach is the gradual opening up of new markets and geographies over time based on commercial criteria.
- Third, like any partnership, success hinges on good communication, transparency, openness, trust, and clarity around rules of the engagement and the measures of success. One panelist noted during the panel discussion that OEMs need to work hard to understand and internalize the customer's perspective to facilitate trust and transparency.
- Fourth, it is important for OEMs to work with a single party or authority within the government that is empowered to negotiate and carry out agreements. Agencies have different mandates according to their level of involvement (*see Exhibit 2, page 9*). Some countries have multiple entities with competing or diverging views, which makes negotiating offset agreements difficult or impossible.

Exhibit 2

Offset agencies have different and distinct mandates according to their level of involvement

Offset Agency Roles



Source: Strategy&

The buyer's view of offsets

Besides generally echoing many of the OEMs' opinions, the buyers on the panel cited some key additional requirements they believe are necessary for an offset agreement to work. The buyers were represented by the Tawazun Economic Council, the entity mandated to diversify the UAE's economy and create new ventures in various sectors by partnering with international defense contractors.

- First, both sides need to exercise a great deal of flexibility in the relationship — which will take at least two or three years to establish. If one side takes a rigid “my way or no way” approach, the relationship will be rocky and likely will not fulfil expectations.
- Second, buyers need to shift away from the old strategy of creating new domestic companies to fulfil offset obligations. In the past, such companies have often been built on overly optimistic forecasts and have ended up failing. Instead, buyers need to identify and network with established, successful small and medium-sized enterprises and use offsets to develop them.
- Third, to develop industry capabilities, the quality of the jobs associated with the offset agreement is highly important. Hence, buyers should not just focus on the number of jobs created. Also, the education agreements associated with these jobs should be designed to help develop the entire domestic industry, not just to train individuals for a single employment opportunity.

An offset methodology

In our experience, four methodological elements have a significant impact on an offset's success: objectives, types, policy components, and governance. However, we have found that before addressing these elements, governments must first develop a national industrial strategy/policy that sets and articulates national goals and establishes a coherent approach to pursuing those goals. These national goals can include the capabilities (military, industrial, etc.) that need to be built locally, job creation, and economic development.

For example, the Indian government has undertaken a slow and effective program of deregulation and modernization of the defense industry to expand indigenous manufacturing capacity. Any entirely Indian owned firm may apply for a defense license to supply arms to the state, as can firms with up to 26 percent foreign ownership. As a result of deregulation, the range of domestic aerospace firms available to partner with Western companies with offset obligations has widened, which has resulted in more employment and has brought more technology know-how into the country.

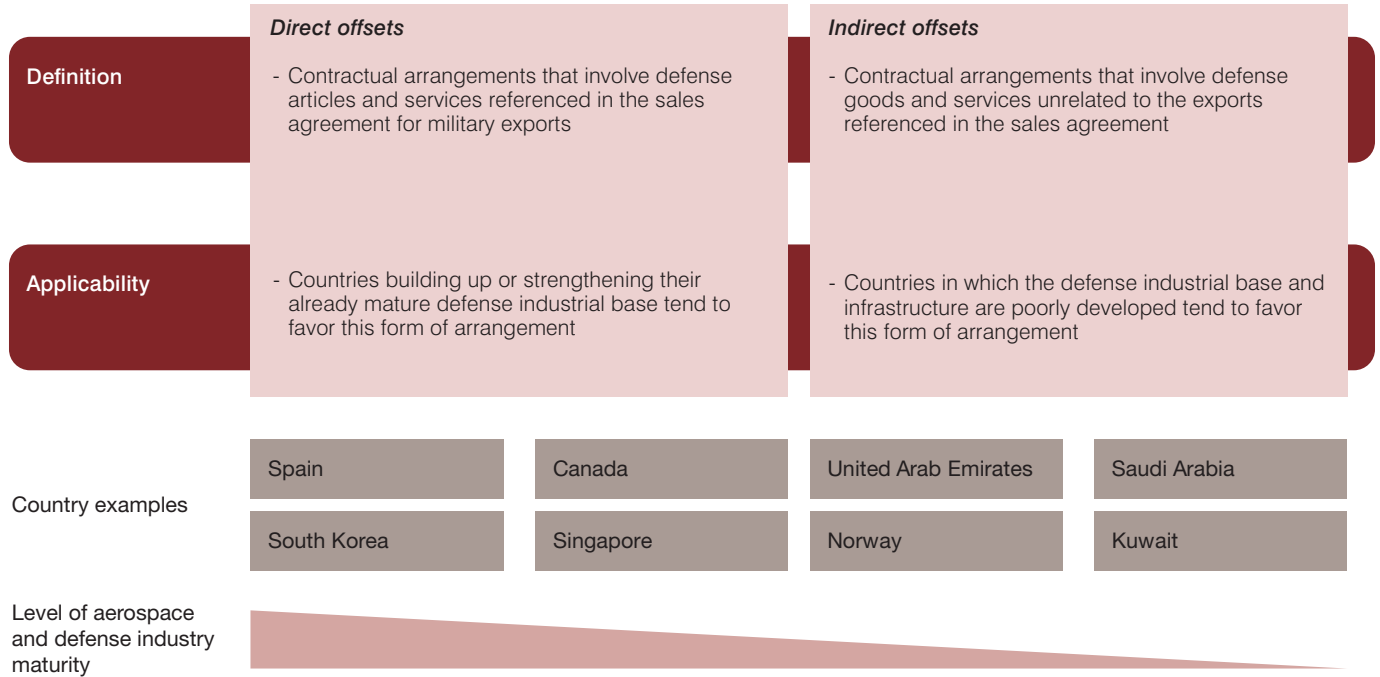
Each country will have its own particular national industrial strategy that directly shapes the vision of the offset program and drives the setting of program objectives. However, a number of interlinked best practice requirements are necessary to ensure that an offset program is successful.

- Offset objectives: These need to be clearly articulated in line with the strategy — such as building certain capabilities, creating jobs, or providing high-value training.
- Offset types: These need to be clearly articulated in line with the strategy. If the strategy is to build specific capabilities, then the government should strengthen direct offsets. However, if the goals are more socioeconomic, then a broader mix of indirect offsets is appropriate (*see Exhibit 3, page 13*).
- Offset policy components: These need to be tailored to the offset types. And all these components — contract value, offset requirements, method of valuation, non-fulfillment penalty, and so forth — need to be fair and transparent to ensure that both sides understand and agree on the terms of success.
- Offset governance: This must be designed to control the offset policy components. Additionally, governance should avoid overlaps of roles and responsibilities among the various entities, which can dilute or delay objectives.

Exhibit 3

The maturity level of the buyer countries influences the type of offset

Offset Agency Roles



Source: Strategy&

Conclusion

Traditional offsets have sometimes been controversial, but more recently both buyers and sellers are coming to understand that offsets can be an effective means of establishing long-term relationships with clear economic benefits for both sides. For OEMs pursuing global sales, offsets can help establish global development capabilities in emerging markets. For emerging countries, offsets are a way to accelerate their own path to industrial and economic development. Offset alignment among buyers and sellers is genuinely achievable as long as both sides approach the offset correctly.

Endnotes

¹ Sikorsky Aircraft Corp., “Sikorsky and Turkey Sign BLACK HAWK Helicopter Licensing and Manufacturing Agreements,” March 4, 2014 (<http://tinyurl.com/obflayx>); Ümit Enginsoy, “US firm sweetens Turkey helicopter bid,” *Hürriyet Daily News*, January 16, 2011 (<http://tinyurl.com/otr3yux>).

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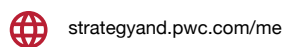
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