strategy&

Formerly Booz & Company

The emerging GCC defence market

The $30 billion opportunity

Strategy& is part of the PwC network

Contacts

Abu Dhabi

Bob Mark
Senior executive advisor
+971-2-699-2400
bob.mark
@strategyand.ae.pwc.com

Bassem Fayek
Manager
+971-2-699-2400
bassem.fayek
@strategyand.ae.pwc.com

Dubai

Haroon Sheikh
Partner
+971-4-390-0260
haroon.sheikh
@strategyand.ae.pwc.com

About the authors

Haroon Sheikh is a partner with Strategy&, part of the PwC network. He is based in Dubai and is the leader of the defence and operations practices in the Middle East. He is an expert on military logistics and supply chain improvement strategies. His work has been recognized in the highest military circles and institutions in the region.

Bob Mark is a senior executive advisor with Strategy& in the Middle East. He is based in Abu Dhabi and works with clients in the public and private sectors, primarily in defence and security in Europe and the Middle East. He has extensive experience in leadership, strategy development, organizational design, transformational change, and large-scale efficiency programs in the U.K., the U.S., and the Middle East. He has been responsible for innovative thinking in major acquisition, logistics transformation, and public–private commercial programs.

Bassem Fayek is a manager with Strategy& in the Middle East. He is based in Cairo. He works with clients in the public sector, with a focus on defence. He has advised clients on the revamping of their logistics support processes, in particular in the defence sector.

Sarah Dagher, Reza Jan, and Rob Ryder also contributed to this report.

Executive summary

The countries of the GCC[1] spend US$130 billion each year on defence, much of which goes to contractors in other countries. As a result, the region has little to show in terms of local defence manufacturing capabilities. Based on our analysis, other countries that spend far less on defence are far more advanced in their ability to design and manufacture defence systems.

Given the current geopolitical uncertainty, GCC governments will continue spending heavily on defence, but they must spend more thoughtfully. By changing their approach, governments can develop a more vibrant manufacturing sector in the region, with more jobs for GCC nationals. In the next decade, demand for local defence products and services could grow to approximately $30 billion annually from a current level that we estimate to be around $6 billion.

To achieve this, however, all stakeholders need to make changes:

- GCC buyers will need to coordinate and consolidate purchases — rather than buying weapons and systems piecemeal, as they currently do. In this way, they can boost the interoperability among national forces and reduce complexity in maintenance and supply chains.

- Local contractors need to increase their capabilities, evolving from mere suppliers of spare parts to sophisticated partners that can guarantee military assets are available.

- Governments must invest to help the local defence industry advance, and foster direct collaboration among stakeholders.

Developing the emerging GCC defence market so that local industries become the main players will be a complex and lengthy process. GCC governments will keep spending large amounts on defence. However, these governments should ensure that it will be local industry that will benefit.

Big spenders

Since the end of the Cold War, global defence budgets have been shrinking, with the notable exception of the GCC's. In the aggregate, GCC countries currently spend more than $130 billion each year on defence. We estimate that of this total, $60 billion goes on procurement and services. These are high figures by any standard. GCC defence budgets are 7.9 percent of global defence expenditures and exceed the combined defence budgets of the U.K., France, and Italy. NATO asks its members to allocate 2 percent of GDP to defence, and the global average for defence spending is a little over 2 percent. The GCC countries spend more than four times as much (*see Exhibit 1*).

Exhibit 1
The GCC countries are among the world's highest defence spenders

Defence spending in US$ billions, 2015

	Defence	GDP	% GDP
Saudi Arabia	87.2	653.2	13.3%
United Arab Emirates	23.0	345.5	6.7%
Oman	9.8	58.5	16.8%
Kuwait[1]	7.0	120.7	5.8%
Qatar	3.7	185.4	2.0%
Bahrain	1.4	30.4	4.6%
GCC total	**132.1**	**1,393.7**	**9.5%**[2]
World	**1,676**	**73,171**	**2.3%**[2]

[1] Estimate

[2] Average

Source: IMF; SIPRI; Strategy& analysis

These large defence budgets have allowed GCC countries to build sizable military arsenals. Yet that spending has not led to a corresponding benefit for their economies in terms of a local defence industrial base. Indeed, we estimate that the GCC spends only around $6 billion annually on local procurement and services. GCC forces have typically purchased most of their defence equipment, either directly or indirectly, from overseas. Meanwhile, the bulk of defence industrial capability in Saudi Arabia and the United Arab Emirates (UAE) — the most significant players — is focused primarily on low-value-added manufacturing (such as assembling finished goods or licensed production) and maintenance, repair, and overhaul (MRO).

Over the last 20 years, GCC countries have attempted to improve on this performance, through joint-venture contracts, offsets, and other measures. Although these arrangements have some advantages, they are limited in how much they can achieve. For example, joint-venture deals with international original equipment manufacturers (OEMs) have given local players greater access to technology. However, the OEM's home country often puts constraints on which technologies can be transferred, sometimes leaving buyers with inferior "export versions." Similarly, offset agreements ensure that a percentage of the contract value is spent in the region, but do not stipulate where or how that investment is made. As a result, it is typically concentrated in basic manufacturing processes, such as the assembly of components that were finished elsewhere and shipped in. The workforce on these projects often consists mostly of expatriates rather than GCC nationals. Unsurprisingly, the region has lagged behind in building a local capability to design and manufacture defence platforms and technology.

The region has lagged behind in building a local capability to design and manufacture defence platforms and technology.

Structured correctly, GCC defence budgets could be a means to fuel economic growth, create jobs, and develop more advanced industrial and technological sectors in the region. There is an opportunity for policymakers to grow industrial localisation because of their continual need to spend large amounts on defence due to geopolitical uncertainty, and their need to seek more efficiency and value from what they are spending on, due to the economic environment. Some governments are increasingly requiring that contracts go to local suppliers and more is being spent locally (see Appendix *"Putting strategy into action"*). For example, the Saudi Vision 2030 requires that 50 percent of the country's defence procurement be sourced "onshore." If other nations were to set a similar goal of 50 percent, then given current procurement and services expenditure of $60 billion annually, that would mean that local products and services could be worth more than $30 billion a year.

More bang for the buck

Other countries that spend less on defence than the GCC as a proportion of GDP have managed to achieve more in terms of defence manufacturing and support capabilities. What is notable about countries such as Australia, Pakistan, South Korea, and Turkey is that they have developed local defence industrial bases despite very different levels of overall economic development (*see Exhibit 2*).

Exhibit 2

Some countries with smaller budgets have more defence industrial capabilities than the GCC

Country	National defence budget (US$ billions)	Defence company	Flagship products	Total defence exports, 2015 (US$ billions)
South Korea	**36.4**	Korea Aerospace Industries	- Fixed-wing aircraft (light attack planes, jet and turboprop trainers, single-piston engine four-seater) - Rotary-wing aircraft (transport and light attack, commercial) - Unmanned aerial vehicles - Airframe components for Airbus and Boeing	3.6[2]
		Hanwha Techwin	- Artillery systems (self-propelled howitzers) - Aircraft engines	
Italy	**23.8**	Leonardo (formerly Finmeccanica)	- Fixed-wing aircraft (trainers, attack jets) - Rotary-wing aircraft (light, medium, attack, transport) - Aerostructures for Airbus, Boeing, and ATR - Avionics; radars; command, control, communications, computers, and intelligence (C4I) systems - Weapon systems	8.9[3]
Australia	**23.6**	Thales/ BAE Systems	- Components for a wide range of international programs - F-35 composite structures, electro-optic systems, radar system components - Munitions, rifles, vehicles - Naval destroyers	1.3[4]
Turkey	**15.3**	Turkish Aerospace Industries	- Rotary-wing aircraft (attack, utility) - Aerostructures for Airbus, Bombardier, Sikorsky, AugustaWestland, Boeing, and Korea Aerospace Industries - F-16 production and modernization - UAVs - F-35 components	1.6[5]
Pakistan	**9.5**	Heavy Industries Taxila	- Main battle tanks - Towed howitzers - Armoured personnel carriers	No data available
		Pakistan Aeronautical Complex	- Fixed-wing aircraft (attack jets, trainers)	

Source: Company websites; SIPRI Yearbook 2016

These countries have leading international companies with export capabilities, such as Italy’s Leonardo (formerly Finmeccanica) and Pakistan’s Heavy Industries Taxila, which manufactures main battle tanks and other military vehicles. Another successful example is Turkish Aerospace Industries, which has moved from assembly to becoming an OEM in its own right, with R&D and commercial products and services across the aerospace spectrum. The company is building components for the F-35 Joint Strike Fighter, including centre fuselages, composite skins, and air inlet ducts.

Although all of these countries started with strong industrial bases, which they adapted to military requirements, what made the difference was that they had sound policies, investments, and trade deals. Despite spending a smaller combined total on defence than the GCC, these countries were able to coordinate the government, military buyers, and local suppliers to create a local industrial base to meet much of their military demand.

How to spend to invest

GCC countries need to look at defence purchasing as more than just spending to acquire systems. Spending is also about investing in a local defence industrial base that will never be subject to the decisions of other countries on technology transfer, that creates jobs and growth, and that allows GCC countries to provide for their own defence needs. This requires three major steps.

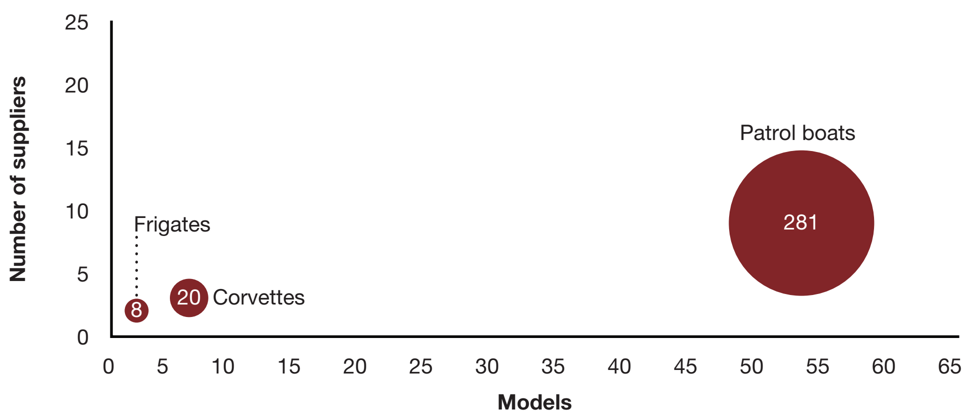
1. Buyers need to consolidate purchases and platforms

One issue that GCC countries need to resolve is their fragmented array of defence systems. Military buyers often have wide latitude to make purchasing decisions, and they have been understandably concerned about relying too heavily on a single supplier or source country. However, that has led to an extremely disparate set of assets across forces and nations (*see Exhibit 3*). For example, GCC armed forces currently use:

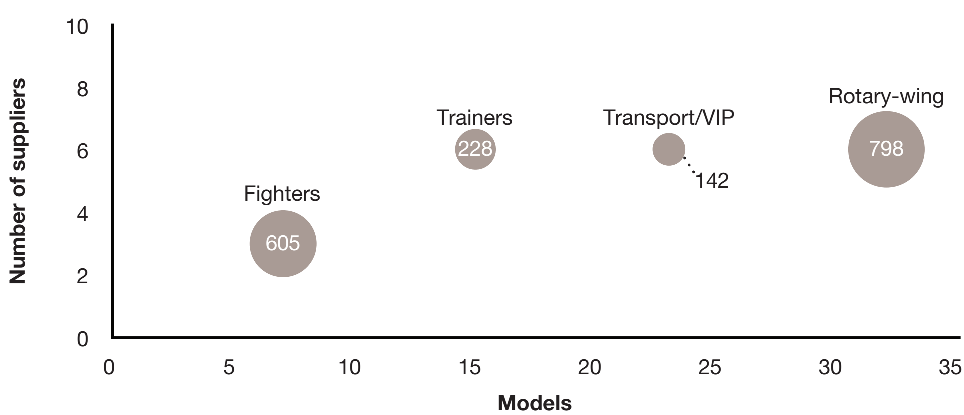
- more than 16 variants of armoured personnel carriers (APCs) from 12 countries
- more than 25 types of artillery, with only 841 pieces in the entire region
- 32 models and variants of rotary-wing aircraft (798 in total), sourced from six countries
- 53 patrol boat models, sourced from nine countries

Exhibit 3
There are too many defence platforms in the GCC

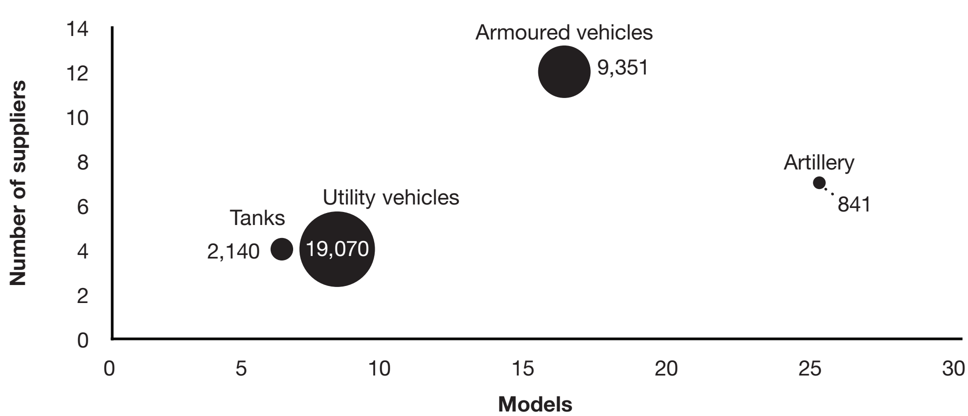
Maritime platforms



Aerial platforms



Ground platforms



Source: Strategy& analysis

Fortunately, not all categories are fragmented. The GCC countries use relatively few tank variants: Bahrain, Kuwait, and Saudi Arabia primarily use U.S.-made M1 Abrams, along with the M60 Patton (as does Oman). The UAE mostly uses French-made AMX-30s (as did Qatar until recently). There is similar concentration in areas such as utility vehicles and naval surface combatants.

High levels of fragmentation benefit suppliers, not customers. Fragmentation leads to unnecessary complexity in supply chains, maintenance, and interoperability among GCC forces. Moreover, the GCC's operational requirements can be met without such a broad portfolio of military assets. There is room to consolidate these purchases, improving operational effectiveness and logistics efficiency. For example, Abu Dhabi Ship Building is developing landing craft for the UAE as well as other customers in the region, such as Bahrain and Kuwait.

Consider rotary-wing aircraft, one of the most fragmented categories. Forces need to run training facilities for pilots across all the varying platforms and have more complex MRO facilities. There are significant synergies if GCC forces could reduce their rotary aircraft to just four categories: attack, light, medium, and heavy. Even if there were two variants of each category, the total number of variants and models would drop by 75 percent.

2. Local contractors need to develop stronger capabilities
Industry players will need to work directly with governments and militaries, through joint-management and risk-sharing initiatives that increase transparency and lead to better sharing of information. In addition, contractors will need to become more innovative and proactive in developing solutions that reduce the cost of defence procurement and support — for which there should be clear financial incentives.

This is a different way of working to what prevails and will require changes at many GCC contractors. Supplier–customer relationships need to be less adversarial and more based on mutual support.

Already changes are afoot to accelerate the localisation of defence industries. The type of service required of contractors has developed in recent decades, particularly for MRO. Initially, armed forces in the region acquired new platforms and systems from established OEMs in other countries. They then operated and maintained that equipment using a mix of national and on-loan personnel, due to limited national capabilities. Subsequently, governments sought to increase the use of local manpower, through nationalization initiatives for both the operations and maintenance of military platforms.

Recently, GCC militaries have entered a third phase of modernization and have shifted from outsourced, and typically offshore, maintenance to onshore MRO contractors. Moreover, militaries are growing more sophisticated in their demands. Rather than buying spare parts and individual services, they are buying operational time for military platforms, vehicles, and systems — freeing military personnel to focus on operational tasks.

This transformation is likely to continue and become a core requirement of military procurement in the region over the coming years. It will lead to greater private-sector involvement in areas that the military once handled, and it will likely increase the size of the local defence market — particularly for local MRO contractors. Yet it requires that these contractors build up the requisite capabilities to deliver. By their nature, contracts based on availability and/or capability tend to entail longer-term relationships and more direct collaboration between defence suppliers and military customers. Moreover, they transfer risk from militaries to suppliers, which commit to addressing any and all issues to ensure that platforms are available as per the terms of the contract.

The goal is not to provide availability at any cost. Rather, companies need to develop solutions that are economically viable for both the military and the industry partner, and to develop the broader economy's base of knowledge, skills, and ability.

3. Governments need to directly support industry players

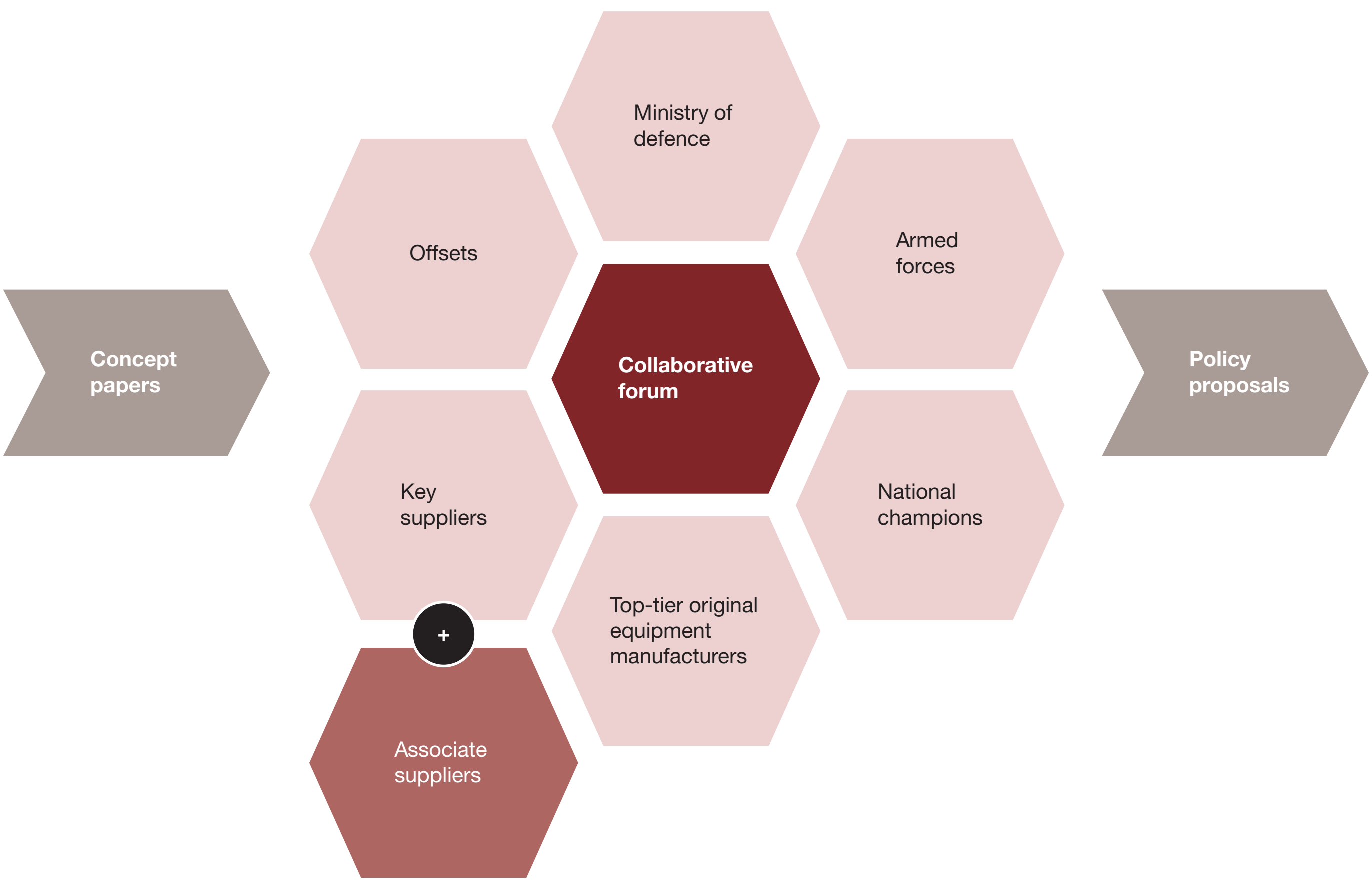
GCC governments will need to continue investing heavily to support their defence industries. Like their global competitors, these industries cannot develop without government support. Over the last 25 years, the global defence market has become consolidated, reduced to a handful of global players. Most contractors are supported to some degree by their national governments. This support involves either direct subsidies or R&D funding.

In addition, stronger local military capabilities reinforce operational sovereignty, ensure secure supplies, and are a source of national pride. Furthermore, military design and manufacturing capabilities can stimulate research and development, create skilled jobs for local talent, and help economies to diversify away from oil and gas.

However, to capture these benefits, GCC governments need to work directly with local industries, effectively partnering for the mutual benefit of both sides. Already, collaborative forums are starting to emerge in the region to develop defence industrial capabilities, with close coordination among military buyers, ministries of defence, and key domestic and foreign contractors (*see Exhibit 4*).

Exhibit 4

A model for collaboration among local suppliers, leading OEMs, ministries of defence, and military buyers



Source: Strategy&

Conclusion

Developing a GCC military industrial base is an ambitious and attainable goal. Other countries have done more with less, including some countries with lower levels of economic development. The GCC has the advantage of large military budgets, a drive for efficiency, and the ability to capitalize on lessons learned in other regions. By changing their approach, GCC governments can invest in the region's future and transform it from a defence consumer to a defence producer.

Appendix

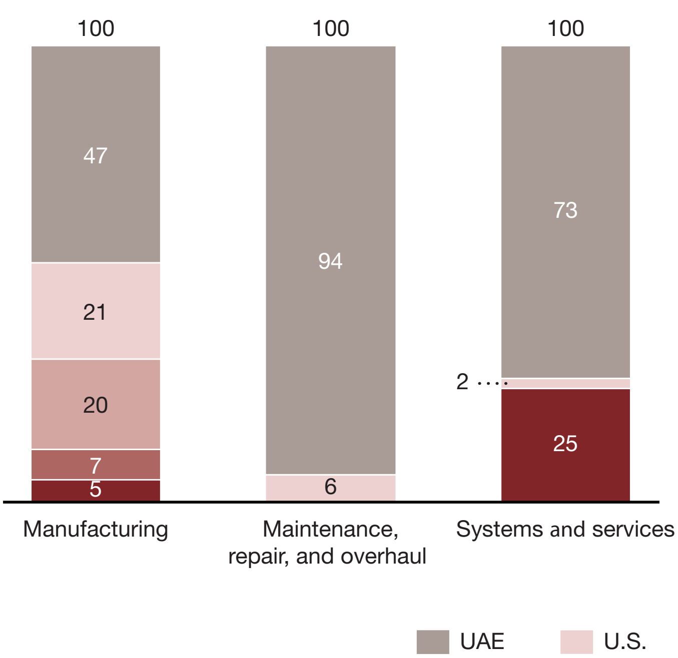
Putting strategy into action

Deals announced at the most recent International Defence Exhibition & Conferences (IDEX) in Abu Dhabi in 2015 and 2017 show the shift in procurement to local contractors. At the 2017 event, nearly 60 percent of the deals announced were awarded to companies based in the UAE, which represented 56 percent of the more than AED 10 billion ($2.7 billion) in total deal value (*see Exhibit 5*). UAE suppliers dominated the contracting for MRO operations, with 94 percent of all deals. UAE-based companies also won 73 percent of the services contracts, and 47 percent of the deals for manufactured products.

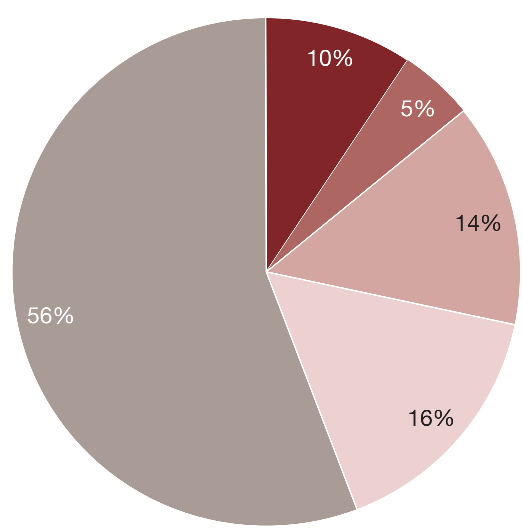
More notable is that the UAE military is aligned with the UAE's defence industrial strategy and is deliberately — and consistently — choosing to buy from domestic companies. This is a positive indication for investment in the UAE, because local industry can grow only under the patronage of military buyers and users.

Exhibit 5
The UAE dominated IDEX deals in 2017

Total deals by type, %



Total deals by country, %



Source: Strategy& analysis

References

[1] The GCC countries are Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates.

[2] Joyce Lee and Tony Munroe, "South Korea seeks bigger role in global arms bazaar," *Reuters*, April 22, 2015 (http://www.reuters.com/article/us-southkorea-defence-exports-idUSKBN0ND0TW20150422).

[3] Tom Kington, "Accuracy of Italian Defense Exports Report up for Debate," *Defense News*, May 17, 2016 (http://www.defensenews.com/story/defense/international/europe/2016/05/17/italy-exports-arms-defense/84434206/).

[4] "Australian defence export licence figures revealed," *Customs Today*, March 9, 2016 (http://www.customstoday.com.pk/australian-defence-export-licence-figures-revealed/).

[5] Burak Ege Bekdil, "Turkey Launches 'Aggressive' Defense Export Campaign," *Defense News*, January 19, 2017 (http://www.defensenews.com/articles/turkey-launches-aggressive-defense-export-campaign).

Strategy& is a global team of practical strategists committed to helping you seize essential advantage.

We do that by working alongside you to solve your toughest problems and helping you capture your greatest opportunities.

These are complex and high-stakes undertakings — often game-changing transformations. We bring 100 years of strategy consulting experience and the unrivaled industry and functional capabilities of the PwC network to the task. Whether you're charting your corporate strategy, transforming a function or business unit, or building critical capabilities, we'll help you create the value you're looking for with speed, confidence, and impact.

We are a member of the PwC network of firms in 157 countries with more than 223,000 people committed to delivering quality in assurance, tax, and advisory services. Tell us what matters to you and find out more by visiting us at strategyand.pwc.com/me.

www.strategyand.pwc.com/me