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The future of GCC defence investment

Six ways to build national capabilities and generate financial returns

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Executive summary

There has been significant activity in the defence industrial landscape in the Gulf Cooperation Council (GCC)[1] in recent years, with governments and private-sector companies seeking to localise defence spending, develop indigenous capabilities, and generate a return on investment. Despite this activity, there has been limited progress in terms of capability development. Armed forces in the region still depend heavily on foreign original equipment manufacturers (OEMs).

To stimulate progress, GCC governments and defence companies should exploit their main advantage: abundant capital in sovereign wealth funds. By investing their funds strategically, decision makers can move faster to build up the region's defence manufacturing capabilities and localise production of defence products and services, while still generating attractive returns. Specifically, there are six themes for defence investment:

- invest directly in mature companies
- invest in startups through a venture capital (VC) structure
- expand GCC companies through regional joint ventures (JVs)
- invest in companies that lack capital
- set up leasing companies
- outsource support functions

All of these options require the definition of a clear investment strategy in advance. The strategy should include a target focus for deals, a business model, levers for value creation, and considerations of the overall portfolio structure.

A better approach to developing indigenous capabilities

Governments and armed forces in the GCC have launched concerted programs in recent years to localise defence spending and build up the region's defence industrial ecosystem. However, decision makers have struggled to allocate resources such as capital and talent when determining which programs and technologies to develop in-country. Simultaneously, recent developments in technology and the shift toward digital warfare have had a significant effect on the defence and security landscape. These changes have made technology and software as important to defence as the products of heavy industry.

In this environment, it is not realistic for small countries to develop advanced platforms exclusively through their own resources, nor should they need to. For example, developing an indigenous aircraft platform can take decades. Many of the large and costly platforms that exist today are the products of multinational consortia in which countries participate based on their substantial capabilities (such as the Eurofighter Typhoon). Attempting to build too much in-country can also lead to disappointing results because of biases among decision makers.[2]

Rather than chasing after unfeasible defence options, GCC countries should focus on a narrower set of advanced capabilities and technologies. GCC defence companies should put their efforts into small-scale systems and components based on artificial intelligence (AI), autonomous systems, robotics, cybersecurity, and system integration. Given that the GCC countries are relatively small and do not possess the heavy manufacturing capabilities of larger, more developed economies, developing such technologies is a more viable option than seeking to build large-scale defence platforms.

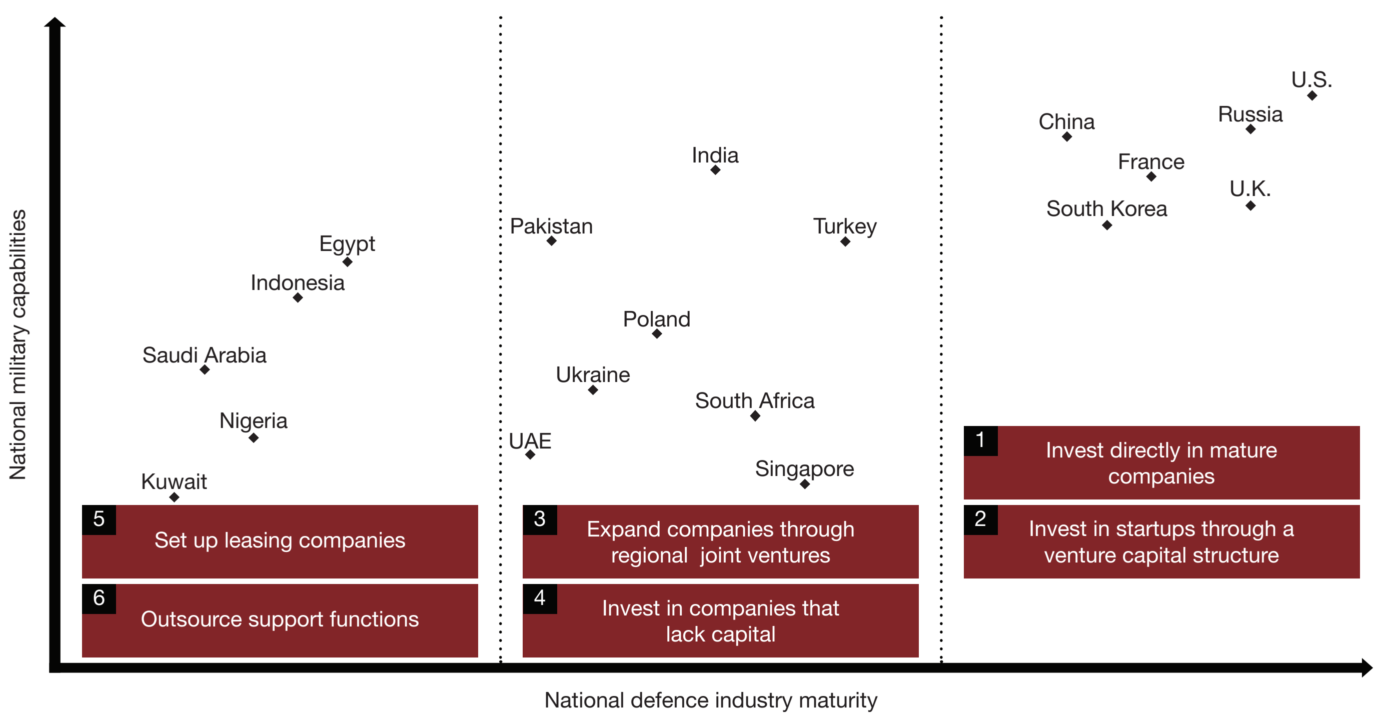
These technologies are becoming more important as they underlie defence and security offerings, and they will give any defence industry an edge in the global market. Such technologies are also attractive from a financial standpoint because they require far less capital than large-scale platforms and systems. What is also appealing is that these technologies require less human intervention from industry during the manufacturing process and from armed forces during operations.

Six investment themes

To develop these advanced capabilities and technologies, GCC governments, sovereign wealth funds, and private-sector defence companies need a strategic approach to investment.

There are six potential investment themes across a range of maturity levels for the national defence industry and national military capabilities (*see Exhibit 1*). These themes also involve different degrees of managerial involvement, from largely passive investments to those requiring direct oversight of daily operations.

Exhibit 1
Six investment themes for GCC defence investment



Note: UAE = United Arab Emirates

Source: Strategy&

1. Invest directly in mature companies

The most direct option is for a GCC government, sovereign wealth fund, or companies to buy ownership stakes in mature defence companies. How much they purchase, and the nature of the ownership, will depend upon the investment objectives, size of the acquisition, and any restrictions that apply to the target company. Such investments will likely be in developed markets that already have mature defence industries, and which have a wide portfolio of companies serving the national and foreign markets.

One approach is to invest in the stock of publicly traded defence companies. For the five years up to the end of the first quarter of 2019, the increase in the value of publicly traded U.S. defence companies outpaced that of the overall S&P 500. Rather than treating such investments as purely financial vehicles, GCC investors could link their purchase of stock to some kind of preferential treatment. This could include the potential for cooperation between the investing country and the company itself. Similarly, one's standing as a significant shareholder, or potentially even a board member, can help investors stay current on global defence industry trends and developments.

2. Invest in startups through a VC structure

GCC governments and companies could invest in young startups that focus on unique defence-relevant technologies and applications, such as AI, autonomous systems, space, and cybersecurity. In essence, this means acting as a VC firm. Some organizations have achieved this by creating a holding company with the explicit mandate to identify and then acquire, or invest in, promising startups. For example, Lockheed Martin has created a VC unit called Lockheed Martin Ventures. Boeing has a similar unit called Boeing Horizon X.

To pick the right investments, players need to build the internal capabilities to identify and assess emerging defence technologies. This capability can involve collaborations with research institutions. Such VC units often require physical proximity to startup ecosystems. Airbus Group recently opened a facility in Silicon Valley called A3 specifically to identify these kinds of opportunities. Were GCC countries to follow this route, they would obtain early access to emerging technologies.

3. Expand GCC companies through regional JVs

GCC governments can help defence companies in the region grow, thereby making them more capable and able to achieve scale. They can encourage more cross-border defence business, pool defence demand, and launch JVs as a means of developing scale and regional defence capabilities.

There are already some GCC-based defence companies that handle maintenance, repair, and overhaul (MRO) for platforms and/or systems. Other companies manufacture or trade defence products and services. These companies, however, cannot grow rapidly because they serve only a few customers: the national defence and security forces. Consequently, these companies cannot build economies of scale and operational efficiencies. These firms could achieve such scale by serving customers across the region. At the same time, GCC countries could aggregate their defence demand, thereby allowing GCC defence companies to operate in a larger market. There is sufficient volume for this model to work in servicing patrol boats, rotary wing aircraft, armoured personnel carriers, and utility vehicles.[3]

GCC countries can also set up JVs specifically to take over the functions of OEMs in the region. Such JVs would serve multiple countries based on their providers' capabilities, platform similarities, access to capital, and cross-border collaboration mandates. Through these JV arrangements with OEMs, GCC-based companies can transfer technology and further develop their own sovereign capabilities.

4. Invest in companies that lack capital

GCC countries can use their ample funds to help fast-growing defence-related companies in emerging markets, enterprises that are often short of capital. The key is to invest in emerging markets in which defence spending is rising, and where companies have strong technical capabilities yet lack sufficient capital due to management or broader economic issues. Such emerging markets include Egypt, India, Indonesia, Malaysia, Pakistan, South Africa, and Turkey. It is important that there be strategic national partners that are onboard.

Such an approach would play to the strengths of GCC countries, which have capital to invest, and would help fast-growing companies in emerging markets, which often have precarious capital positions. Many of these companies have strong products and services, but can struggle to survive when confronted with a large one-time order, a backlog in receivables, or powerful customers and suppliers. A capital infusion would allow these companies to shore up their foundation by revising supplier contracts, strengthening customer relationships, and improving their financial management overall. For GCC entities, such investments could lead to partnerships with potential suppliers.

5. Set up leasing companies

GCC militaries do not need to buy all of their equipment outright. Instead they can lease or license from companies. This approach works for generic equipment that militaries do not need to customise, such as transport and refuelling platforms. Financially, it allows armed forces to avoid digging deep into their pockets to procure equipment. At the same time, it provides long-term business for the defence industry, which can lease equipment to customers and provide training and MRO services. This licensing model will become more attractive as platforms become more modular and digital, increasing the importance of regular upgrades as opposed to one-off purchases.

Several OEMs have already applied this concept. Boeing has an operating lease agreement to provide C-17 transport aircraft to the U.K.'s Ministry of Defence. The company has a similar arrangement to provide KC-46 tanker aircraft, based on the 767 passenger jet, to the U.S. Department of Defense. BAE Systems also leases frontline equipment such as aircraft and ships to the U.K.

One way to pursue this investment theme would be to set up a leasing company to acquire redundant equipment from other companies or armed forces, refurbish and upgrade these assets, and then lease them to militaries. This means adopting an operating expenditure model instead of the traditional capital expenditure model.

6. Outsource support functions

Outsourcing models can be attractive investments because they provide mission-critical support services to armed forces while controlling costs. This is a compelling proposition for GCC armed forces as they seek to protect their countries against regional threats and improve interoperability among forces, while dealing with fiscal pressure increases. Some GCC armed forces are outsourcing many support and ancillary operations to industry players so that they can focus on their core capabilities. Outsourcing also helps forces engaged in prolonged and intensive operations because it allows them to have outside companies provide support functions through availability contracts that guarantee a certain level of operability.

Beyond cost efficiencies, outsourcing allows national companies to forge JVs with international experts that can catalyse the development of national capabilities. MRO, mapping, training, and information systems are just some of the areas in which national defence companies can deliver services that are more efficient on commercial terms.

A well-defined investment strategy

Before they choose their investment themes, GCC governments, sovereign wealth funds, and companies must first define an investment strategy that aligns with the mandates and aspirations of all stakeholders. In particular, they need to find a balance between maximizing financial returns and setting appropriate risk and liquidity expectations. For example, investing in companies specialising in established, proven technologies such as land vehicles carries less risk than investing in defence startups working with emerging technologies.

Second, the investment strategy needs a clearly defined focus. This should include the means of sourcing deals, the asset class, the investment horizon, the size of each investment, and the maturity level of target companies. All of these factors will guide management teams as they identify the right opportunities.

Third, investors must determine the right business model for each investment, especially any value-creation levers and funding/monetization. For example, some investments may benefit from operational improvements, technology upgrades, or market expansion. Depending on the target maturity and portfolio priorities, dedicated teams may be needed with a focus on operational improvement and portfolio integration. In all cases, investors need a clear idea of their anticipated return on investment before the deal closes.

Fourth, the investment strategy should include what are the desired portfolio structure and concentration thresholds, in terms of asset classes, sectors, geographic markets, or individual investments (*see Exhibit 2*).

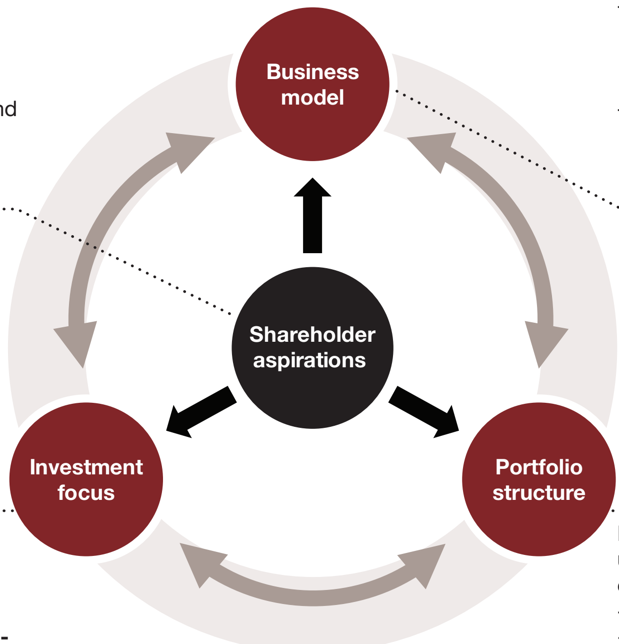
Once the strategy is in place, GCC entities must create a framework to assess investment opportunities in selected defence systems, platforms, regions, or other factors. Next, investors can begin to generate a pipeline of potential investment opportunities and evaluate them at a high level. As some of these opportunities materialize, there must be comprehensive due diligence for all commercial, operational, technical, financial, and legal matters.

Exhibit 2
A defence investment strategy

Defines shareholders' risk-adjusted expectations:
- **Internal rate of return**
- **Risk appetite**
- **Liquidity and monetization**

Sets high-level strategy constraints and preferences including:
- Limitations
- No-go verticals

- Identifies how **value is created and captured**
- Defines the **capital in** (fund-raising, paid-in capital, re-injections, co-investments, debt level, management fees, success fees, etc.)
- Defines the **capital out** (dividends, principal capital repayments, operational expenditures, proceeds from exits, etc.)



- Defines the **deal sourcing** strategy and **focus** across themes, including asset classes, geographies, and investment stage
- Defines the **monitoring and involvement process** through the **value creation play** adopted and the stakes chosen
- Outlines potential **exit** strategies

Defines risk management strategies using **portfolio construction and concentration** including:
- Exposure to asset classes
- Exposure to geographies
- Exposure to sectors
- Exposure to single entities

Source: Strategy&

Conclusion

Although GCC governments, defence players, and sovereign wealth funds have made some progress in building up a national defence ecosystem, they also need to consider new approaches that can more rapidly capture financial and/or strategic value. Investment in existing businesses is one option, but investors should also focus on emerging digital technologies and applications. Implemented correctly, the approaches discussed here will develop defence industries in GCC countries, generate financial returns, and equip the region to protect itself better.

Endnotes

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

[2] Dr. Shihab Elborai, Dr. Raed Kombargi, Dr. Yahya Anouti, and Anthony Yammine, “Three biases that impede local content development: Seeing through the illusions,” Strategy& 2018 (https://www.strategyand.pwc.com/me/report/three-biases-impede-local-content).

[3] Haroon Sheikh, Bob Mark, and Bassem Fayek, “The emerging GCC defence market: The $30 billion opportunity,” Strategy& 2017 (https://www.strategyand.pwc.com/me/report/emerging-gcc-defence-market).

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